Deep Integration: National Treatment and Tax Harmonization in North America

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Trade and investment rules within North America are moving far beyond the removal or reduction of tariff barriers on goods to the removal or reduction of most barriers to flows of goods, services, and investments. One result is increasing regionalization of market access and foreign investment rules (with some notable exceptions, such as competition policy). This integration is occurring because the three major North American governments and their multinational enterprises (MNEs) want to remove intracontinental impediments to the flow of goods, services, and investments. These desires have had their most tangible result in the 1994 North American Free Trade Agreement (NAFTA), but policies such as bilateral tax treaties are also promoting integration.

Deep integration increases the effectiveness of the liberalized trade and investment area. It is occurring in two ways: first, through the NAFTA's extension of the norm of national treatment, which is typically found in multilateral trade agreements, to crossborder

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flows of investment, services and intellectual property; and, second, through increased policy coordination and harmonization in specific areas such as corporate income taxation.

The purpose of this paper is to document these two processes of deep integration, to discuss their implications, and to draw some conclusions about further policy directions.

Deep Integration

The United Nations Conference on Trade and Development (UNCTAD) categorizes regional integration schemes as shallow or deep integration (UNCTAD 1992, 35). *Shallow integration* involves removing barriers to trade in goods — that is, forming a free trade area or a customs union. *Deep integration*, on the other hand, means removing internal barriers that discourage the efficient allocation of international production within the region — that is, eliminating barriers to trade in business services, instituting the right of establishment and fair treatment for foreign direct investment (FDI), and providing protection of intellectual property.

At a minimum, deep integration requires that each of the countries involved extend the national treatment standard to most business activities emanating from the other partners. *National treatment* means that a country treats foreign activities performed within its borders in the same or equivalent way that it treats domestic activities. Once country A's goods, services, and investments have cleared the border and become part of country B's internal market, they must be treated in line with domestic goods, services, and investments. National treatment allows each member country to apply its own laws within its own borders according to its own objectives.

National treatment, however, is not enough. Deep integration requires that countries go further. They must harmonize and coordinate a variety of domestic policies (industrial and fiscal, for example) and adopt common standards in various fields (labor, health, and safety, for example) that are not directly trade related but affect multinational enterprises.

The removal of internal barriers facilitates the exploitation of economies of scale and scope at a regional level by encouraging MNEs to site plants in their most efficient locations. Thus, although shallow integration is often government led, deep integration is driven by MNEs' desire to improve their competitive position within the regional market.

For example, in the case of Canada-US regional integration, UNCTAD argues that the 1965 auto pact and tariff reductions under successive rounds of the General Agreement on Tariffs and Trade (GATT) had already caused significant integration of trade and production by the mid-1980s. However,

> [f]irms were unable to reap the full benefits of cross-border integration because of the lack of a policy framework which would assure an open trading environment and closer policy coordination between the two countries. (1992, 36.)

The 1989 Canada-US Free Trade Agreement (FTA) and the NAFTA promoted further integration by MNEs because the agreements included many FDI-related issues, such as national treatment, performance requirements, and restrictions on expropriation. The movement to harmonize corporate income taxes within North America, although still in its infancy, also reflects the desire to ensure an open trading environment and closer policy coordination within the region.

Deep Integration through the NAFTA

The NAFTA, which was implemented in Canada, the United States, and Mexico on January 1, 1994, will eliminate many trade barriers between the three countries over the next 15 years as they abolish or make more transparent all tariffs and most nontariff barriers.[1]

1 For discussion of some details of the NAFTA, see Eden (1994b; 1995); Gestrin and Rugman (1993; 1994); Graham and Wilkie (1994); Hufbauer and Schott (1993); Kudrle (1994); Lipsey, Schwanen, and Wonnacott (1994); and Rugman and Gestrin in this volume.

The NAFTA builds on and in most cases supersedes the 1989 FTA.[2] Both free trade agreements provide national treatment for goods from member countries under the terms of the GATT (Lipsey, Schwanen, and Wonnacott 1994, 160).

National treatment is also guaranteed for investment. Chapter 16 of the FTA, dealing with investment, already required Canada and the United States to treat each other's investors in the same manner as domestic investors. It applied national treatment only to new nonconforming measures, however; the rest were grandfathered. The NAFTA, on the other hand, guarantees national treatment as well as most-favored-nation (MFN) treatment (NAFTA investors must be treated at least as well as any foreign investor) for all the partners' investments and investors, including firms controlled by non–North Americans, except for measures and sectors specifically listed in annexes to the agreement. (For example, many existing federal measures such as those affecting Canadian cultural industries are exempt.) Public procurement and investment incentives are not included, nor are FDI restrictions on national security grounds (see Rugman and Gestrin in this volume). The broad protection for member country investors and investments is, however, unprecedented in trade agreements.

The FTA had also introduced a variety of measures designed to encourage the free flow of capital between Canada and the United States. Export and production-based performance requirements, such as those Canada's Foreign Investment Review Agency used to require for new entry, were disallowed, and Investment Canada's function as a screening agency was severely curtailed. The NAFTA extends the list of proscribed performance requirements and mandates that most existing requirements be phased out over ten years. The agreement forbids restrictions on capital movements, including all types of payments and profit remittances, except for balance-of-payments reasons. Expropriation is severely restricted, unless a government can show a public purpose, acts on a nondiscriminatory basis, and

2 In some instances (for example, Canada-US tariff schedules and energy trade), the NAFTA simply confirms that the FTA continues to apply.

provides full and prompt payment of fair compensation. The NAFTA also introduces a new trinational dispute settlement process. Investors can seek binding arbitration for violations of NAFTA obligations from either the World Bank's International Center for the Settlement of Investment Disputes (ICSID) or the United Nations Commission on International Trade Law (UNCITRAL).

In sum, the NAFTA goes well beyond the protection of investment and market access achieved through the various multilateral rounds of the GATT. This success suggests that regional trading agreements among small groups of like-minded states can be an effective way of deepening integration.

Corporate Income Taxation

Deep integration requires more than national treatment of crossborder flows of goods, services, and factors. Policy coordination and harmonization are necessary ingredients in ensuring MNEs have effective market access to all countries in a regional trade agreement. Which policies should be harmonized first, and why?

Harmonization of corporate income taxes (CITs) is one of the first policy areas that governments should explore to deepen existing integration efforts. With the NAFTA eliminating trade barriers and providing a level playing field for foreign investments in member countries, differences in corporate income tax policies are becoming more important as determinants of crossborder intrafirm trade and FDI flows, and may lead to more MNE-state disputes.

The reasons for urgency are several. First, a regional free trade area increases the potential competition for investment within it because tariffs, one of the major reasons for inward FDI, are eliminated. Although tax differences alone may not lead an MNE to locate in country A rather than in country B, there is good evidence that differences in tax incentives, CIT rates, or the treatment of foreign source income do affect the location within a region once it has been chosen as the investment location (Dunning 1993, chap. 18). The International Monetary Fund (IMF), after reviewing tax policies and FDI in developing countries, concludes:

> As far as tax policy is concerned, governments which want foreign investment to play a role in their development programmes are well advised to design their tax structure with an eye to the taxation level in the other countries which are potential competitors as venues for foreign investment. (1990, 190.)

Second, as Mathewson and Quirin (1979, 93) caution, when countries move to a free trade area, the scope for manipulating transfer prices (over- or under-invoicing intrafirm trade flows) generally rises as crossborder tariffs disappear and trade volumes increase. Their study finds that taxes and tariffs tend to have offsetting impacts on MNE location decisions so that the combination of CITs and tariffs is self-policing, reducing the incentive for transfer price manipulation. If tariffs are absent (as within a free trade area), the authors conclude, such manipulations may increase. To avoid these distortions, they recommend that free trade be accompanied by a move to harmonized national tax levels.

Third, as Vernon notes in a discussion of MNE-state relations after the NAFTA:

> The NAFTA agreement does not deal directly with the many questions of taxation in which the three signatory governments have mutual or conflicting interests. Nevertheless, as the operations of multinational enterprises expand and become more deeply integrated across national borders, the agreement promises to complicate and exacerbate these questions substantially. (1994, 32.)

He argues that the NAFTA will exacerbate two tax-related problems: the determination of taxable profits (how MNE profits are allocated, for tax purposes, within the free trade area); and the measurement of regional content (how the rules of origin are satisfied when most products are transferred within the MNE). He concludes on a pessimistic note, "[t]he tax problems described above are not created by the NAFTA; they have existed as long as governments have taxed the units of multinational networks" (Vernon 1994, 34).

In brief, CIT policies matter because significant differences in tax rates and bases can offset the liberalizing effects of a free trade

agreement. Removing internal barriers to regional trade requires more than applying national treatment to crossborder flows of goods. Also needed are harmonization and coordination of domestic policies that affect MNE location and investment decisions.

The Source and Residency Principles

The implications of the NAFTA for corporate income taxation are now being addressed by policymakers as they move slowly to harmonize CITs in Canada, the United States, and Mexico. Because tax policies and bilateral tax treaties in all three countries follow the norms laid out by the Organisation for Economic Co-operation and Development (OECD), a short review of some of its the principles — specifically, the source and residency principles — is the easiest introduction to a consideration of what needs harmonizing and why.

Since issuing its first model tax convention in 1963, the OECD has endorsed the concept of the separate entity as the underlying basis for allocating taxing rights to business income between countries. The right to tax depends on the existence of a nexus (connection) between the taxing jurisdiction and the business enterprise. The nexus differs under the source and the residency principles.

The Source Principle. For a taxable nexus to be established under the source principle, the business must have a permanent establishment in the taxing jurisdiction.[3] Once the MNE's income is effectively connected to a source country, it can tax all items of income that arise within its borders.

Permanent establishments within a country are treated as separate entities. Each taxing authority has jurisdiction over the income and assets an entity earns or receives within the country up to its water's edge. Affiliates of an MNE are treated as separate legal

3 A permanent establishment is an extension of an enterprise used to carry out its business in a foreign location. It need not be locally incorporated. Examples include a local sales office, a construction project, and an assembly plant, each in a foreign location.

entities and income is apportioned between them, assuming intrafirm transactions take place at arm's-length prices. The traditional tax is the CIT.

The source country generally levies withholding taxes on income paid to nonresidents that arises from passive investments or casual, nonrecurring activities within its boundaries. Interest, dividends, rents, royalties, and management fees are examples of the types of income remittances that normally attract a withholding tax. Tax rates are normally in the 10 to 25 percent range but are generally reduced through bilateral tax treaties to 0 to 10 percent.[4]

The Residency Principle. The nexus for taxation under the residency principle depends on an enterprise's "living" within a jurisdiction. This point becomes somewhat confusing because the definition of residency varies between countries. In some countries, including the United States, a business is resident in the jurisdiction where it is incorporated; in others, including Canada, the United Kingdom, and Australia, the location of the "seat of management" determines residency.[5]

The residence country normally levies a CIT on the enterprise's income, allowing the deduction of expenses incurred in producing it. Generally, the net income from all an enterprise's units is consolidated for tax purposes. The jurisdiction of residence has the right to tax both the domestic- and the foreign-source income of its residents. Some countries exempt income earned abroad; others tax worldwide income.

4 The practice of cutting withholding taxes through bilateral tax treaties provides an example of reciprocity. The practice of reciprocal cutting of tariffs under the various GATT rounds is somewhat equivalent. When governments bilaterally negotiate tariff cuts, however, they must extend the benefits to all member countries under the MFN rule; bilateral tax treaties do not have the same provisions, so the benefits go only to the two parties. The NAFTA investment chapter does provide that benefits received by member countries must be at least as generous as those extended to nonmembers, but it does not apply to taxes.

5 In determining the seat of management, *de facto* control matters more than *de jure* control (Arnold 1986, 10).

Sorting Out the Principles. Under the jurisdictional norms, the primary (but not exclusive) right to tax business profits goes to the country of source. While the residence country has the primary right to tax most other categories of income (Arnold 1986, 174; Dunning 1993, chap. 18; Eden, forthcoming, chap. 2; Langbein 1986, 630), it is obligated to eliminate double taxation. In effect, since the source country has the prior right to tax, the residence country is expected to modify its rules to take account of source taxation. These rights become binding commitments when governments negotiate bilateral tax treaties; indeed, a key purpose of such treaties is to specify how the two countries are to tax foreign-source and nonresident income.

The tax boundaries established in most developed countries are thus roughly the same: the fiscal authority taxes the worldwide income of its residents and the domestic-source income of its nonresidents (Arnold 1986, 3). Many countries tax the worldwide income of their residents but defer tax on foreign-source income until it is repatriated. Most countries grant a foreign tax credit for the CITs and withholding taxes paid in the host country, up to the level of the home-country tax. In certain cases, the residence country exempts all foreign-source income, taxing only on a territorial basis. In still others, certain categories of foreign-source income are exempt while others are taxable as earned.

Taxing Multinationals in North America

Taxing MNEs involves two types of taxation: taxing the foreign-source income of domestically owned firms and taxing the domestic income of foreign-owned firms. The US, Canadian, and Mexican tax rules as they apply to resident and nonresident corporations all use the concepts of residence and source taxation.[6]

6 A good, recent outline of the US tax rules with respect to international income is Hufbauer (1992); see also Ault and Bradford (1990). On the Canadian regulations, see Arnold (1986); Boidman and Gartner (1992); Brean (1984); Brean, Bird, and Krauss (1991); Eden (1988a; 1988b; 1991; forthcoming). For Mexico, see Price Waterhouse (1995), especially chaps. 16, 18, and 24.

The United States

Taxing the Foreign-Source Income of MNEs. Using the residency principle, the United States taxes its residents — persons and corporations — on their worldwide income. For enterprises, US rules distinguish between a *foreign branch*, an entity owned 100 percent by its parent that does not have an independent legal existence separate from the parent, and a *controlled foreign corporation* (CFC), an entity more than 50 percent owned by US shareholders (with each holding at least 10 percent) that is incorporated in a foreign country and thus considered an independent entity. Branch profits are taxed as earned, but domestic firms are permitted to defer US taxes on income earned by their foreign subsidiaries until the CFC income is repatriated.

The federal CIT rate in 1994 was 34 percent (see Table 1). Many US states and some cities also tax corporate income at rates that vary between 0 to 12 percent; these levies are deductible against the federal CIT (Boidman and Gartner 1992, 30–31). For many firms, the combined federal-state tax rate (with the deductibility factored in) is thus 46 percent.

The US CIT applies to the domestic income of US MNEs plus accrued foreign branch profits, head office fees, and interest payments remitted from foreign affiliates. Dividends are grossed up by the amount of any foreign CIT and brought into taxable income. A foreign tax credit (FTC) is provided for withholding taxes on remitted interest, head office payments, and dividends; for foreign branch taxes; and for foreign CITs on dividends. The credit cannot exceed the US rate of tax.

Since 1986, the US rules "look through" (characterize) types of incomes and place them in separate baskets with separate FTC calculations, in order to reduce tax avoidance. Foreign earnings must be pooled and the FTC calculated using cumulative, rather than annual, foreign-source income and taxes. The rules also require US parents to allocate a percentage of overhead to their foreign subsidiaries; creditable expenses are calculated, however, on a consolidated basis, rather than by affiliate.

Table 1: *Statutory Corporate Income Tax Rates within the NAFTA, 1994*

	United States	Canada		Mexico
		Manufacturing	Nonmanufacturing	
		(percent)		
Federal CIT	34	24	29	34
Subfederal CIT rate[a]	12	14	15	0
Profit-sharing tax	0	0	0	10
Combined federal-state CIT rate[a]	46	38	44	44
Withholding tax on direct dividends	Canada 10 Mexico 5	US & Mexico 10		0
Total CIT plus dividend withholding tax	Canada 51 Mexico 49	44	50	44
Effective Statutory Tax Rates on Profits Earned by:				
US parent with remitted profits from Canadian and Mexican affiliates	46	46	50	46
US parent with no profits remitted from Canadian and Mexican affiliates	46	38	44	44
Canadian parent with remitted profits from US and Mexican affiliates	51	38	44	44
Canadian parent with no remitted profits from US and Mexican affiliates	46	38	44	44
Mexican parent with remitted profits from Canadian and US affiliates	49	44	50	44
Mexican parent with no remitted profits from Canadian and US affiliates	46	38	44	44

[a] In the United States, state CIT rates vary from 0 to 12 percent, and the amount paid is deductible against the federal tax. In this table, New York is used as the example, and deductibility is factored in for ease of comparison. In Canada, provincial CIT rates vary from 8 to 17 percent, and the amount is in addition to the federal tax. In this table, Ontario is used as the example. Mexico has no state income taxes.

In addition, passive income earned by foreign subsidiaries with US parents in situations considered abusive has been taxable as earned since 1962. These situations primarily involve income in tax-haven countries. For example, dividends, interest, rents, and royalties received by a US citizen from a closely held company in Bermuda or the Cayman Islands is taxable as accrued.

Taxing the US Income of Foreign MNEs. Using the source principle, the United States taxes the income of permanent establishments and any income "effectively connected" to that country at the basic federal CIT rate. In addition, a withholding tax of 30 percent is levied on the dividends a corporation remits to its foreign parent. The general rate is 30 percent, but a bilateral tax treaty may reduce it to as low as 5 percent. For example, under the Canada-US income tax treaty, the withholding tax rate on direct dividends is 10 percent; this raises the total tax on dividend remittances made by foreign affiliates in the United States to their Canadian parent from 46 to 51 percent.[7]

Before 1986, the United States levied no tax comparable to the dividend withholding tax on US branches with foreign parents. In 1986, the US government introduced several reforms that reduced tax rates and widened the income tax base (for more information, see Eden 1988a; 1988b). Among them was as 30 percent branch profits tax, introduced as a *de facto* withholding tax on remittances by US branches to their foreign parents.

For many years, the US government also levied a 30 percent withholding tax on interest income paid to foreigners, which they generally avoided through the so-called Dutch treat — the Netherlands Antilles (see Brean 1984; Brean, Bird, and Krauss 1991). That tax was repealed in 1984.

7 The withholding tax is calculated as $w(1-t)$, where w is the withholding tax rate on dividends and t is the corporate income tax rate. Therefore, the combined tax is $t + w(1-t) = 46\% + 10\%(1-46\%) = 51.4\%$.

Canada

Taxing the Foreign-Source Income of Canadian MNEs. Canada taxes residents — individuals and corporations — on their worldwide income (for further information, see Arnold 1986, 149–186; Brean 1984; Brean, Bird, and Krauss 1991). Profits earned from manufacturing and processing activities are taxed at a lower rate than profits from other activities. The federal rate is 29 percent on general profits, reduced to 24 percent for manufacturing profits. The provinces levy additional CITs, varying from 8 to 17 percent. For many firms, therefore, the CIT is 38 percent on manufacturing profits and 44 percent on other activities (see Table 1).

Taxation of worldwide income means residents pay Canadian taxes on their foreign-source income. However, Canada distinguishes between two types of foreign-source income. Income earned through a foreign corporation owned by a Canadian firm (a "foreign affiliate") is not taxed as earned. The treatment depends on whether the foreign affiliate earns exempt surplus or taxable surplus. *Exempt surplus* can be defined as "active business income earned in certain listed countries (generally countries with which Canada has or is negotiating a tax treaty)" (Arnold 1986, 154–155). Dividends paid from foreign direct investments are exempt from Canadian taxation if they are paid out of exempt surplus in the foreign affiliate. Foreign affiliates' active business income losses cannot, however, be deducted from the parent's income.

Taxable surplus basically consists of passive income and active business income earned in unlisted countries. Under the Foreign Accrual Property Income (FAPI) rules, dividends paid out of taxable surplus (for example, foreign portfolio dividends) are included in the Canadian parent's income and subject to the basic Canadian corporate income tax rate; foreign withholding taxes are creditable or may be deducted against the Canadian tax (Arnold 1986, 153–154). Passive income is taxed only when repatriated because the foreign firm is considered a separate entity and not resident in Canada for tax purposes. The definition of what is and what is not FAPI income is difficult. The FAPI rules, which apply only to controlled foreign

affiliates,[8] operate so that income classified as active business income is not subject to them. Therefore, FAPI income is basically passive investment income, such as income from property, inactive businesses, and certain types of service income and capital gains.

Thus, Canada has a mixed exemption-credit system: active business income is exempt; dividends out of other income are taxed when repatriated with a foreign tax credit given for host-country taxes. This regime was instituted in 1972; until then, all foreign-source income was exempt from Canadian tax.[9] Now, dividends out of active business income in listed countries can be repatriated tax free; dividends out of other income are taxed when repatriated.[10]

8 A foreign affiliate is a "foreign corporation where a Canadian taxpayer owns, directly or indirectly, at least ten percent of the shares of any class" (Arnold 1986, 165). A controlled foreign affiliate is one controlled, directly or indirectly, by five or fewer Canadian taxpayers; their owning 50 percent or more of the voting shares of a foreign affiliate makes it subject to the FAPI rules.

9 In commenting to the Committee on Public Accounts about the pre-1972 situation, Brian Arnold said:

> Prior to 1972, if you were a wealthy individual in Canada and you didn't want to pay tax in Canada, it was simple as going to a tax haven country and for a few hundred dollars incorporating a company and basically taking your funds that were sitting in bank accounts or investments in Canada and shifting them to the tax haven company. Then you didn't pay any tax in Canada on that income. The FAPI rules stopped that, very effectively. (Canada 1993, 40:13.)

10 In 1992, the auditor-general, in his annual report to Parliament, questioned the amount of taxes paid by Canadian MNEs on their foreign-source income, arguing that hundreds of millions of dollars was not being paid because of weaknesses in the Canadian regulations. Specifically, the report questioned the tax-exempt status of certain dividends received by Canadian MNEs from their foreign affiliates; problems with the anti-avoidance FAPI rules; and the deductible status of interest on borrowed money used by Canadian MNEs to earn foreign-source income. The Department of Finance disagreed, arguing that Canadian tax regulations had to conform to the international norms established by the OECD; that the rules were designed not only to raise revenues but also to facilitate the competitiveness of Canadian MNEs on their foreign activities; and that little tax revenue would be gained by tightening the rules. The result, however, was a partial tightening of the legislation in 1994 (see Eden, forthcoming).

Taxing the Canadian Income of Foreign Multinationals. Canadian jurisdictions use the source principle to tax foreign-controlled permanent establishments. They pay at the federal plus the provincial statutory CIT rates. Most tax deductions and credits available to domestic firms are also available to foreign establishments. Thus, national treatment is the norm. Foreign-owned branches, with certain exceptions (for example, banks), pay the federal and provincial CITs and an additional branch tax of 25 percent of taxable income, from which CITs are deducted prior to calculating the branch tax. Withholding taxes on remittances are levied when these funds are repatriated. The general withholding tax rate on dividends is 15 percent, unless reduced by tax treaty. Canada taxes most interest payments at 15 percent, but the rate is often reduced by tax treaty to 10 percent.

Mexico

Taxing the Foreign-Source Income of Mexican MNEs. Mexico taxes individuals and businesses on their worldwide income. In 1988, the rate was 42 percent; it was subsequently reduced to 35 percent and then, in 1994, to 34 percent for both individuals and corporations. A foreign tax credit is offered up to 34 percent of taxable foreign-source income (Price Waterhouse 1995).

At first blush, the Mexican income tax system looks similar to the US and Canadian systems, but there are some striking differences (McLees 1992; 1994). First, Mexico indexes most income bases and deductions for inflation (for example, real, not nominal, interest costs are deductible expenses). Thus, the tax base can differ even if rates are roughly equivalent. Second, net income is generally subject to a mandatory 10 percent profit-sharing payment, which is not deductible against the CIT to the extent that the firm's Mexican employees receive nontaxable fringe benefits. Third, Mexico levies a 2 percent business assets tax as a minimum income tax, unless the taxpayer declares at least a 5.7 percent taxable return on the assets tax base. Fourth, Mexico has no state income taxes. Assuming a corporation pays more than the minimum income tax, the effective statutory CIT rate in Mexico is, therefore, 44 percent (see Table 1).

Taxing the Mexican Income of Foreign Multinationals. Nonresident individuals working in Mexico pay a statutory withholding tax rate of 30 percent on gross income, regardless of where it is paid or the form it takes, even if the company does not have a permanent establishment in Mexico. Reduced rates apply to tax treaty countries and to the *maquiladoras* (McLees and Reyes 1993). Dividends paid to residents or nonresidents from previously taxed income are not taxable, so there is no withholding tax on dividends. Thus, the statutory tax rate on the remitted profits of permanent establishments is 44 percent (see Table 1). The business assets tax applies to permanent establishments and can be a source of double taxation.[11]

Recent Moves toward Tax Harmonization

Clearly, the US, Canadian, and Mexican CIT systems, although based on the OECD model tax conventions, differ in their effects on North American MNEs. For example, the United States taxes its own MNEs on their worldwide income, giving a tax credit for foreign income taxes paid on foreign-source income when that income is repatriated. Canada, on the other hand, exempts foreign-source income from taxation if it is active business income.

These differences can affect FDI decisions and offset the deep integration that is occurring as a result of the NAFTA. The three governments are responding by harmonizing their CIT systems through bilateral tax treaties and by extending national treatment to taxation, in selected areas, through Article 2103 of the NAFTA.

Tax Harmonization through Bilateral Tax Treaties

Bilateral tax treaties provide foreign investors with a more secure and similar tax regime and are thus one way in which governments

11 The business assets tax is not creditable in the United States because it is not an income-based tax. Therefore, US affiliates in Mexico that pay the business assets tax face double taxation on income remitted to their US parents.

encourage inward FDI. Table 2 outlines the key features of the current bilateral tax treaties among the NAFTA countries.

The 1991 Canada-Mexico Tax Treaty

In 1991, Canada and Mexico signed a bilateral tax treaty, effective as of January 1, 1992. It provides several examples of a move toward deep integration at the tax level. First, national treatment is provided by guarantees of taxes that are both no more burdensome on non-nationals than on nationals and no less generous to nonresidents than to residents.

Second, the treaty includes an MFN clause, a general commitment to ensuring that the tax on a nonresident company provides no more burden than that afforded to residents of a third country. For example, if a Canada-US tax treaty offers US- controlled permanent establishments in Canada a better tax rate than Mexican-controlled affiliates receive under the Canada-Mexico tax treaty, this article ensures Mexican affiliates will receive MFN treatment.

Subsequently, the 1994 protocol to the treaty added an article providing Canada with partial MFN treatment for Mexican withholding taxes on interest and royalties.

The 1992 US-Mexico Tax Treaty and 1994 Tax Protocols

The United States and Mexico signed their first bilateral tax treaty in September 1992. It took effect in January 1994 and was followed quickly by two protocols.[12] As Table 2 shows, the withholding rates under these agreements rates are generally lower than those negotiated under the Canada-Mexico tax treaty.[13] As these rates are being

12 For detailed information on these agreements, see Gordon and Ley (1994); Matthews (1993); McLees (1992; 1994); McLees and Reyes (1993); Morrison (1993; 1994); Perez de Acha (1993; 1994).

13 One of the interesting components of the US-Mexico tax treaty is Mexico's 4.9 percent withholding tax on interest payments. Almost all interest payments...

Table 2: ***Bilateral Tax Treaties among the NAFTA Countries***

	1991 Canada-Mexico Tax Treaty and 1994 Tax Protocol	1992 US-Mexico Tax Treaty and 1994 Tax Protocols	1995 Canada-US Tax Protocol
		(percent)	
Withholding tax rate on			
Direct dividends[a]	10	5	5 (7, 6, then 5)
Portfolio dividends	15	10 (15 for 5 years)	10
Interest[b]	15	4.9 (banks, 10 for 5 years) 15 (other)	10
Royalties	15	10	0
National treatment	• The tax on non-nationals will be no more burdensome than that levied on nationals in the same circumstances • The tax on a permanent establishment will be no less favorable than that levied on residents carrying on the same activities		
National treatment for NAFTA investors		A resident of a state that is a NAFTA party may qualify for treaty benefits in certain circumstances	

MFN treatment	The tax on a company owned or controlled by residents of the treaty partner will be no more burdensome than that levied on companies owned or controlled by residents of a third country		
Restricted MFN	If Mexico signs a treaty with an OECD state setting a withholding tax on interest or royalties below 15%, Mexico will grant Canada the lower rate, but not below 10%[c]	If the United States signs a treaty with a third country that provides a lower withholding rate on direct dividends, both parties will apply the lower rate[c]	
Exchange of information	The parties agree to exchange information about taxes covered by the convention	The parties agree to exchange information about all taxes[c]	The parties agree to exchange information about all taxes
Assistance in tax collection			The parties agree to help collect each other's taxes
Arbitration panels		After three years, the parties will consult about exchanging notes to establish a binding arbitration procedure for disputes that cannot be resolved by competent authority[c]	After three years, the parties will consult about exchanging notes to establish a binding arbitration procedure for disputes that cannot be resolved by competent authority

[a] Mexico does not levy a withholding tax on direct dividends.

[b] The United States does not levy a withholding tax on interest payments.

[c] 1994 protocol.

phased in, the MFN clauses in the 1994 protocol to the Canada-Mexico treaty should provide additional benefits to Canadian investors in Mexico.

The US-Mexico treaty incorporates the same national treatment article as the Canada-Mexico treaty. In addition, it provides a (so far unique) form of national treatment for NAFTA investors: the definition of subsidiaries eligible for benefits under the treaty is any subsidiary that is wholly owned, directly or indirectly, by publicly traded companies in any of the three NAFTA countries, with a minimum 50 percent ownership in either the United States or Mexico. Thus a 51-49 percent US-Canadian joint venture in Mexico is eligible for US-Mexico tax treaty benefits (Morrison 1994, 829–831). Although the treaty includes no general MFN clause, there is a restricted clause whereby the United States agrees that, if it should negotiate lower withholding taxes on direct dividends with a third country, both parties will adopt that lower rate.

Two interesting extensions appeared in the 1994 protocols to the treaty. In anticipation of the NAFTA, US-Mexico crossborder flows increased significantly and were expected to continue to do so in the future. Therefore, tax authorities on both sides of the border had an increasing interest in data collection for tax purposes. First, the two governments agreed to exchange information on all taxes, not just those listed in the OECD convention.[14] Second, the two agreed to discuss in three years' time establishment of a binding arbitration procedure for resolving bilateral tax disputes.[15]

Note 13 - cont'd.

...from Mexico flow north to the United States; therefore, the negotiators realized that any reduction in the withholding tax would reduce Mexican tax revenues per dollar of interest outflows. US banks, however, wanted a low withholding tax rate so their income would fall in the general financial services basket, rather than in the high withholding tax basket. The rate at which the interest payments would have to move into the latter basket is 5.0 percent, so a 4.9 percent rate was the maximum Mexico was able to negotiate (Morrison 1994).

14 Which is the standard article — see the Canada-Mexico treaty for an example.

15 The 1994 protocol also details how the procedure would work. Because arbitration can be an effective dispute resolution technique (particularly in cases where...

The 1995 Canada-US Tax Protocol

The 1980 Canada-US tax treaty, amended by protocols in 1983 and 1984, came into effect on January 1, 1985, and in 1990, the Canadian and US governments began negotiations on a new protocol. First signed on August 31, 1994, and then revised and signed on March 17, 1995, the protocol came into effect on January 1, 1996. It enhanced investment access for MNEs in at least five ways.

First, the protocol substantially reduced withholding taxes on crossborder financial flows, reducing the costs of remitting funds from foreign affiliates to their parents and between affiliates. Taxes on direct dividends fell from 10 to 5 percent, those on interest payments went from 15 to 10 percent, and those on royalties were eliminated.

Second, the nondiscrimination clause, which previously had applied only to the CIT in both countries, was extended to all US and Canadian taxes. This means that neither government can use tax policies to discriminate against firms located in its territory that are owned by residents of the other country. There is, however, no NAFTA-investor clause, such as exists in the US-Mexico treaty, nor are there any MFN articles that could further reduce Canada-US withholding taxes.

Third, the 1985 treaty had allowed the two federal taxing authorities to exchange information on income, estate, and gift taxes. The 1995 protocol expanded that exchange to cover all taxes imposed by the two countries and to allow the disclosure of information related to income or capital taxes to provincial and state tax authorities. Thus, it is now easier for each government to obtain information about related-party transactions in the other country (for example, the US Internal Revenue Service can ask Revenue Canada for infor-

Note 15 - cont'd.

> ...the tax amounts in dispute are very large and one of the governments is unwilling to provide offsetting relief), the introduction of such a procedure is to be welcomed. For the 12 members of the European Union, a similar clause came into force for a trial three-year period starting in 1995.

mation about tax payments made by, say, General Motors of Canada to its US parent).

Fourth, the protocol has a new article dealing with mutual assistance in tax collection. Each country has undertaken, but is not obliged, to collect the other's "finally determined" taxes as if they were its own. Again, this clause encourages cooperation between the tax authorities.

Last, the two parties may agree to add a voluntary arbitration procedure to the mutual agreement article. This decision is to be made three years after the protocol entered into force.

Taxation: An Exception in the NAFTA

Taxation is one of several specified exceptions to the commitments under the NAFTA.[16] Article 2103 states that nothing in the agreement shall "apply to taxation measures" or "affect the rights or obligations of any Party under any tax convention." If an inconsistency between the NAFTA and a bilateral tax convention occurs, the tax convention prevails to "the extent of the inconsistency."

Article 2103 is very clear: in general, the NAFTA does not cover taxes, and where there is a conflict, tax treaties take precedence. That is not the end of the story, however. Article 2103 goes on to specify four general ways in which the NAFTA does apply to tax measures.

Border Tax Adjustments and Export Taxes on Trade in Goods. First, under Article 2103(3), the NAFTA requires that

> Notwithstanding paragraph 2:
>
> (a) Article 301 (Market Access – National Treatment)...shall apply to taxation measures to the same extent as does Article III of the GATT [national treatment]; and
>
> (b) Article 314 (Market Access – Export Taxes) and Article 604 (Energy – Export Taxes) shall apply to taxation measures.

16 The others are general exceptions, national security, balance of payments, disclosure of information, and cultural industries.

The logic of paragraph 2103(3a) is as follows. Under the GATT, national treatment requires that imported goods, once inside the country, be treated no worse than domestically produced goods. Thus, the tax treatment of imports can be no more onerous than that of domestic goods. (This rule is designed to discourage governments from using domestic taxes as protectionist measures.)

In practice, national treatment has meant making decisions about how to provide equivalency for exports and imports in terms of taxes on domestic goods. In other words, what should be done about border tax adjustments? The common approach to this problem (see Jackson 1989, 194–197) is to apply the destination principle, which means providing national treatment in terms of where the goods are finally sold. That is, since a country is the final destination for its imports, it can levy a tax on them equivalent to any similar internal tax it imposes on domestic goods (for example, if it levies a value-added tax [VAT] on domestic goods, it can levy a VAT on imports). And since a foreign country is the final destination for exports, the producing country can rebate the amount of any internal tax on them (for example, exports are VAT exempt). Paragraph 2103(3a) thus allows border tax adjustments similar to those permissible under the GATT.

Paragraph 2103(3b) is straightforward. If export taxes are to be levied, they must apply to all parties and to domestic sales so that no party receives treatment any less favorable than that available to nationals.

Taxes on Services, Financial Services, and Investment. The second general exemption is paragraph 2103(4), which states:

> Subject to paragraph 2:
>
> (a) Article 1202 (Cross-Border Trade in Services – National Treatment) and Article 1405 (Financial Services – National Treatment) shall apply to taxation measures on income, capital gains or on the taxable capital of corporations, and to those taxes listed in paragraph 1 of Annex 2103.4 [the Mexican business assets tax],

> that relate to the purchase or consumption of particular services; and
>
> (b) Articles 1102 and 1103 (Investment – National Treatment and Most-Favored-Nation Treatment), Articles 1202 and 1203 (Cross-Border Trade in Services – National Treatment and Most-Favored-Nation Treatment) and Articles 1405 and 1406 (Financial Services – National Treatment and Most-Favored-Nation Treatment) shall apply to all taxation measures, other than those on income, capital gains or on the taxable income of corporations, taxes on estates, inheritances, gifts and generation-skipping transfers and ...[the Mexican business assets tax].

The paragraph continues, however, and exempts the following taxes: any MFN obligation under a tax convention; any nonconforming provision of any existing tax measure, of a continuation or renewal of any such provision, or of any amendment to such a provision that does not decrease its conformity; any new tax measure that does not arbitrarily discriminate, nullify, or impair the benefits of these articles; and any excise tax on insurance premiums adopted by Mexico.

Traditionally, indirect taxes (sales taxes, excise taxes, VATs) have been considered as eligible for border tax adjustment, while direct taxes (personal and corporate income taxes) have not. The taxes listed in paragraph 2103(4)(a) are direct taxes and, as such, would not be eligible for border tax adjustment. The rule says, however, that where these taxes relate to the purchase or consumption of particular services — where they, in effect, become indirect taxes — they can follow the national treatment rules.

Paragraph 2103(4)(b) expands on this point. National treatment and MFN obligations for investment, services, and financial services apply to all taxes that are not income related (that is, to all other indirect taxes). Grandfathering applies, however; if a tax is nonconforming, it does not have to meet the national treatment standard.

Performance Requirements. Paragraph 2103(5) states that the NAFTA rules outlawing performance requirements "shall apply to taxation measures." The agreement rules out the following types of performance requirements, among others: domestic content rules; prefer-

ences to local products, trade balances, or exchange rate inflows; and ratios of sales to exports or foreign exchange earnings. Thus, taxes or tax incentives cannot be used for these purposes. Requirements to locate production, provide a service, train or employ workers, construct or expand facilities, or carry out research and development are permissible, so taxes or incentives related to them are allowed.

Expropriation and Compensation. Paragraph 2103(6) allows an investor to invoke a claim for compensation if taxation has been used to expropriate an investment as defined in Article 1110 (Expropriation and Compensation). The taxpayer must first get a ruling from the "appropriate competent authorities" that expropriation did occur. If there is no ruling or if it is unfavorable, the investor can still submit a claim for arbitration under Article 1120, either under the ICSID convention or the UNCITRAL arbitration rules. (This procedure is similar to the dispute settlement provisions in the investment chapter of the NAFTA.)

Deep Integration and Taxes in the NAFTA Countries

Clearly, policymakers in the three NAFTA countries are aware that tax differentials can influence MNE location and investment decisions. Even though the NAFTA generally does not apply to taxation, it explicitly commits the parties to national treatment for taxation in four areas: crossborder taxation (tariffs and export taxes); direct and indirect taxes that affect crossborder trade in business services (although existing derogations are grandfathered); taxes and incentives related to performance requirements; and taxation related to expropriation. Moreover, all three countries have adopted the national treatment norm, reduced their withholding tax rates, and are beginning to link their bilateral tax treaties with the NAFTA.

Deep integration through tax harmonization is, however, just at its beginning in North America. The parties are still in the old mold of bilateral tax treaties based on reciprocal negotiations and bilateral

concerns. Could the three governments take some policy steps that would speed up the deep integration process?

As a first step, I suggest that the three federal tax authorities establish a US-Canada-Mexico consultative committee of senior tax officials who meet regularly to exchange information on tax policy proposals and discuss problem areas, along the lines of the NAFTA committees in the trade and investment areas.[17] This trilateral group should be given the task of harmonizing national tax policies on a regional basis.

As a second step, the three countries should work on extending their bilateral tax treaties to trilateralize them. This could be done by developing parallel sets of articles on, for example, national treatment, MFN status, NAFTA investors, the exchange of information on all taxes, tax collection assistance, and binding arbitration. In effect, the North American bilateral tax treaties could function in the way GATT trade agreements have worked to facilitate deep integration through: substituting withholding taxes for tariffs and then reciprocally reducing those taxes; guaranteeing national treatment; extending all negotiated benefits to treaty partners through MFN status; and establishing a common dispute settlement mechanism. Elsewhere in this volume, Graham and Sauvé discuss extending the concepts of national treatment and MFN status from trade agreements to a multilateral investment agreement. A similar deepening of regional integration could occur through broadening the national treatment and MFN norms within the North American income tax treaties.

As a third step, the three countries could move to adopt a free trade area in taxation by eliminating withholding taxes within the region while allowing each country to maintain its own tax rates *vis-à-vis* other treaty partners. The Canadian and Mexican revenue authorities might resist this proposal because of its revenue implica-

17 Although all three countries are members of the OECD's Committee on Fiscal Affairs and thus meet in multilateral negotiations over the OECD model income tax conventions and transfer pricing proposals, there is no trilateral tax working group equivalent to those established for trade policy officials under the NAFTA.

tions. Because their countries are primarily hosts to FDI from the United States, most of the financial flows from MNE subsidiaries to their parent firms in North America flow out of Canada and Mexico into the United States; eliminating withholding taxes would remove a revenue-generating tax base. On the other hand, if eliminating withholding taxes encouraged more location of FDI in Canada and Mexico, the two countries could gain additional CIT revenues on the source-based income, offsetting the lost withholding taxes.

Fourth, another obvious possibility in tax harmonization is to rewrite Article 2103 of the NAFTA by eliminating the grandfathering provisions that apply to nonconforming measures, formally listing exceptions to national treatment of taxation, and then beginning to harmonize these exceptions.[18]

As a fifth and much later step, the three countries could move to a single North American CIT, with common tax bases and common rates. Given the sensitivity of taxes, the desire of governments to manipulate rates and bases for domestic purposes, and the implications for national sovereignty of moving to trilateral taxation, this move is highly unlikely. However, the proposed trilateral tax committee should establish a working group to consider it and other methods of deepening integration of taxes within North America. The working group could, for example, evaluate the merits of adopting a regional formulary apportionment method (allocating income and expenses based on a formula approach) for MNEs with the majority of their business inside North America.

Conclusions

The policy environment in North America is moving far beyond the simple removal or reduction of tariff barriers on goods implied by a free trade agreement (shallow integration) into significantly deeper integration, which allows free movement of goods, services, and factors. The thread running through the NAFTA is national treat-

18 This is the way the FTA was revised in the NAFTA.

ment: treating foreign and domestic investors similarly under domestic law. In addition, many trade and investment policies are being harmonized and common standards established. Deep integration at the regional level, however, requires both national treatment and policy coordination and harmonization. Since tax differentials can offset the favorable impacts of trade liberalization on MNE competitiveness, effective market access within North America requires government action in taxation to complement the regional integration in the trade and investment policy areas.

Recent harmonization efforts in corporate income taxation do complement NAFTA trade and investment policies in providing better investment and market access within North America. Although tax harmonization is much less advanced than integration through trade and investment policies under the NAFTA, the potential and the rationale for deepening regional integration through trilateralizing tax policy are clearly evident.

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