Tax Discrimination in the NAFTA Bloc: The Impact of Tax and Trade Agreements on the Cross-Border Trade in Services

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This paper considers the impact of international agreements in disciplining tax discrimination affecting cross-border trade in services. It addresses three questions. First, how do tax and trade agreements interact in the discipline of tax measures affecting cross-border service providers? Second, does this interaction result in tax discrimination against foreign service providers in the NAFTA bloc? Third, if so, what remedies, if any, are available to cross-border service providers with respect to tax measures that are discriminatory? The paper concludes with illustrative examples that service providers in the NAFTA bloc, depending on the applicable treaty, are subject to differing tax treatments, are potentially vulnerable to different types of tax discrimination and may be subject to different dispute resolution alternatives. It suggests that the role of taxation in trade agreements is likely to become a compelling issue among nations, and in the ongoing negotiations under the Free Trade of the Americas Agreements.

Cet article examine l'incidence des accords internationaux sur la discipline imposée en cas de discrimination fiscale touchant le commerce et les services transfrontaliers. Il examine trois questions. Premièrement, comment les ententes fiscales et les accords commerciaux interagissent-ils dans la discipline des mesures fiscales qui touchent les fournisseurs de services transfrontaliers? Deuxièmement, cette interaction a-t-elle comme résultat une discrimination fiscale contre les fournisseurs de services de l'extérieur des pays de l'ALÉNA? Troisièmement, si la réponse à cette question est oui, les fournisseurs de services transfrontaliers ont-ils des recours relativement aux mesures fiscales discriminatoires, et quels sont ces recours? L'auteur conclut qu'en plus d'être victimes de discrimination fiscale, les fournisseurs de services transfrontaliers dans le bloc de l'ALÉNA peuvent être soumis à des critères différents lorsqu'il s'agit de déterminer s'il y a eu discrimination fiscale et à des modes différents de règlement des différends.
Introduction

The importance of the cross-border trade in services has been recognized in the last decade in international trade agreements like the World Trade Organization Agreement (WTO Agreement),¹ and the North American Free Trade Agreement (the NAFTA).² Canada, the United States and Mexico, as signatories to both, made and received significant commitments with respect to market access and non-discrimination in the cross-border supply of services. However, trade discipline over direct taxation (income tax),

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including the taxation of foreign service providers, was for the most part carved out of these trade agreements. This was not without considerable controversy. It was widely recognized throughout the negotiations for the General Agreement on Trade in Services (the GATS)\(^3\) that discrimination in direct taxation could have just as deleterious an effect on the cross-border trade in services as the non-tariff barriers under review.\(^4\) Nonetheless, in hotly disputed negotiations resolved virtually on the eve of the deadline for signing the WTO agreement, most obligations with respect to non-discrimination in direct taxation were effectively removed from the GATS. Discipline over direct taxation issues has also been largely carved out of the NAFTA. Instead, bilateral tax treaties patterned on the model established by the Organization for Economic Cooperation and Development discipline the imposition of direct taxes for both WTO and NAFTA signatories.\(^5\) Canada, the United States (U.S.) and Mexico have entered into such bilateral agreements (NAFTA tax treaties).\(^6\)

This paper considers the impact of international agreements in regulating tax discrimination affecting the cross-border trade in services. It attempts to answer three questions. First, how do tax and trade agreements interact in the discipline of tax measures affecting cross-border service providers? Second, does this interaction result in tax discrimination against foreign service providers in the NAFTA bloc? Third, if so, what remedies, if any, are available to cross-border service providers with respect to tax measures that are discriminatory?

\(^3\) WTO Agreement, supra note 1, Annex 1B, General Agreement on Trade in Services, 15 April 1994, B.T.S. 58 (1996) (entered into force 1 January 1995) [GATS].


The paper concludes that in addition to being subject to tax discrimination, cross-border service providers in the NAFTA bloc may be subject both to differing standards in the determination of whether tax discrimination has occurred, and to differing dispute resolution options.

I. International Trade Agreements Affecting Trade in Services

The 1990s witnessed significant global cooperation facilitating the cross-border trade in services. The NAFTA came into effect on January 1, 1994, with respect to Canada, the U.S. and Mexico. The GATS came into force on January 1, 1995, as part of the Agreement establishing the World Trade Organization (WTO Agreement) with some 127 initial Members.7 As signatories to the WTO Agreement, Canada, the U.S. and Mexico agreed to honor all of their obligations under the GATS. They also assumed additional obligations to their NAFTA partners.8 The immediate discussion focuses on these trade agreements. An examination of the NAFTA tax treaties and the specific provisions that impact the cross-border trade in services follows.

1. The General Agreement on Trade in Services (the GATS)

The GATS accord is a multilateral agreement covering trade in the service sectors, which applies to all WTO Member countries.9 Its scope and coverage relies on basic definitions about who is a service supplier, and what is considered a measure “affecting trade in services.”10 The commitments by

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7. This number has now expanded to 147 Member governments accounting for over 90% of the world’s trade.
8. The NAFTA explicitly provides, however, that in case of inconsistency with other agreements, unless otherwise specified in the NAFTA, it will override other agreements that existed at the time the NAFTA became effective (Article 103). The WTO Agreement (1994) became effective after the NAFTA. In the final analysis the choice of forum rules determines which of the WTO or NAFTA rules apply.
9. GATS, supra note 3, Art. 1, para. 2. The agreement covers four basic modes of service delivery: (1) cross-border services supplied from the territory of one party to the territory of another; (2) services supplied in the territory of one party to the consumers of any other (e.g., tourism); (3) services provided through the presence of service-providing entities of one party in the territory of any other (e.g., banking); and (4) services provided by natural persons of one party in the territory of an other (e.g., construction projects or consultancies).
10. Specifically, the GATS applies to measures by Members “affecting” trade in services. A measure is broadly defined as “any measure by a Member, whether in the form of a law, regulation, procedure, decision, administrative action, or any other form.” Trade in services is defined as the “supply of a service.” WTO, EC – Bananas III (US) WTO Doc. WT/DS 27/R/USA (22 May 1997) [Bananas III] defined the scope of application of the Agreement in the following terms: “[N]o measures are excluded a priori from the scope of the GATS as defined by its provisions. The scope of the GATS encompasses any measure of a Member to the extent it affects the supply of a service regardless of whether such measure directly governs the supply of a service or whether it regulates other matters but nevertheless affects trade in services.” Bananas III, ibid. at para. 7.285. The Appellate Body upheld this finding and held that no provision of the Agreement “suggest[s] a limited scope of application for the GATS” WTO, Appellate Body – Regime for the Importation, Sale and Distribution of Bananas, WTO Doc. WT/DS27/AB/R (25 September 1997) at para. 220 [Appellate Body Report].
Members with respect to such measures may be categorized into two broad groups: first, general obligations, which apply directly and automatically to all Members and services sectors; and second, specific commitments concerning market access and national treatment in designated sectors. These specific commitments, set out in individual country schedules, may vary widely in scope between Members.\(^{11}\)

The general obligations assumed under the GATS include a commitment to most favoured nation (MFN) treatment to the service providers of other Members ("foreign service providers").\(^{12}\) This obligation requires that each party "accord immediately and unconditionally to services and service providers of any other Party treatment no less favorable than that it accords to like services and service providers of any other country."\(^{13}\) Some deviation from this standard was permitted provided the Member listed such measures in the "Annex on Article II Exemptions" and the conditions for such exemptions were met.\(^{14}\)

The commitment to provide national treatment to foreign service providers\(^{15}\) under the GATS is limited to those sectors specified in each member’s Schedule of Concessions. Once committed, the Member concerned may not impose discriminatory measures benefiting domestic services or service suppliers. Specifically, each Member must "accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers."\(^{16}\) This

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11. \(\text{GATS, supra note 3, Art. XX}\)
12. \(\text{Other general obligations include transparency with respect to measures of general application, the establishment of national inquiry points to respond to other Members information requests, the establishment of administrative review and appeal procedures, and discipline on the operation of monopolies and exclusive suppliers.}\)
13. \(\text{GATS, supra note 3, Art. II(1). The wording "treatment no less favourable" has been interpreted broadly by the WTO Appellate Body to include both de facto as well as de jure discrimination. See e.g \text{Appellate Body Report, supra note 10 at para. 234}\)
14. \(\text{Almost all countries claimed some MFN exemptions in areas such as civil and maritime aviation, telecommunications and financial services. All exemptions are subject to review and should not last longer than 10 years in principle. Further, the GATS allows groups of Members to enter into economic integration agreements or to mutually recognize regulatory standards, certificates and the like if certain conditions are met. See Schedules to the GATS to view a specific country’s Schedules. For Canada see WTO, Final List of Article II Exemptions, WTO Doc. GATS/EL/16 (1994) [Canada – Final List of Article II Exemptions]. Canada has claimed exemptions for film, video and television co-production, and with respect to fishing, banking, trust and insurance services, air and marine transport, and for certain services related to agriculture.}\)
15. \(\text{The GATS, supra note 3, Art. XVII(1) provides that “each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favorable than that it accords to its own like services and service suppliers”. The GATS limits the application of this standard to those sectors specified in each Member’s Schedule of Concessions, and allows Members to set forth any applicable conditions.}\)
16. \(\text{Ibid., Art. XVII(1)\).}
obligation can be met by providing "either formally identical or formally different treatment so that it accords to its own like services and service suppliers." The key requirement is not to modify, in law or in fact, the conditions of competition in favour of the Member's own service industry in respect of "like" services or service suppliers. Again, the extension of national treatment in any particular sector may be made subject to conditions and qualifications. Each country's commitments thus tend to reflect national policy objectives and constraints, overall and in individual sectors.

One of the most significant areas in which Members have claimed both MFN exemptions and national treatment qualifications is taxation. For example, Canada has claimed a national treatment exemption for tax measures that result in differences of treatment with respect to expenditures made on scientific research and experimental development services. Further exemptions have been claimed at both the federal and sub-central level for small businesses that are Canadian controlled private corporations. The specifics of these exemptions and qualifications are found in each country's Schedule to the GATS.

In addition to the claimed exemptions for tax measures, there are specific provisions in the GATS that further limit both MFN and national treatment obligations with respect to direct (income) tax matters. Of particular significance are Article XIV (d) and Article XIV (e) of the GATS.
Article XIV (d) of the GATS limits the national treatment obligation as it relates to the tax treatment of services. It provides that any Member may adopt or enforce direct tax measures that are inconsistent with national treatment, provided that they do not constitute "arbitrary or unjustifiable discrimination" in trade or services and "provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Member countries." 24 The meaning of the expression "equitable or effective" is defined in a footnote that provides illustrations of taxes and tax policies that may be excluded from national treatment requirements. 25 These include, for example, the right to impose withholding tax. Further, special provisions such as transfer pricing rules to prevent tax avoidance are not automatically considered discriminatory. The footnote also specifies that tax terms or concepts listed describing the 'carve out' of national treatment, be determined according to tax definitions and concepts, or their equivalent under the domestic law of the Member taking the measure. 26 This allows Member governments to exercise wide powers to both safeguard their tax base and to define its scope.

Article XIV (e) of the GATS permits Members to ignore the MFN requirement with respect to discrimination in direct tax matters if the preferential tax treatment of Parties from one country over another is provided for under a tax "treaty". Similarly, the national treatment

24. GATS, supra note 3, Art. XIV(d).
25. GATS, supra note 3, Art. XIV(d). n. 6. Specifically, the footnote refers to the following activities:

Measures that are aimed at ensuring the equitable or effective imposition or collection of direct taxes include measures taken by a Member under its taxation system which:

(i) apply to non-resident service suppliers in recognition of the fact that the tax obligation of non-residents is determined with respect to taxable items sourced or located in the Member's territory; or
(ii) apply to non-residents in order to ensure the imposition or collection of taxes in the Member's territory; or
(iii) apply to non-residents or residents in order to prevent the avoidance or evasion of taxes, including compliance measures; or
(iv) apply to consumers of services supplied in or from the territory of another Member in order to ensure the imposition or collection of taxes on such consumers derived from sources in the Member's territory; or
(v) distinguish service suppliers subject to tax on worldwide taxable items from other service suppliers, in recognition of the difference in the nature of the tax base between them; or
(vi) determine, allocate or apportion income, profit, gain, loss, deduction or credit of resident persons or branches, or between related persons or branches of the same person, in order to safeguard the Member's tax base.

Tax terms or concepts in Article XIV (d) and in this footnote are determined according to tax definitions and concepts, or equivalent or similar definitions and concepts, under the domestic law of the Member taking the measure.

26. Ibid.
obligation has been largely carved out of the GATS where a bilateral tax treaty is in effect between the Member countries. This latter exception was not without considerable controversy. The final GATS agreement reflects a compromise of sorts. Under the agreement, the non-discrimination article in existing bilateral tax treaties has primacy over the GATS national treatment provisions in resolving disputes involving the taxation of services and service suppliers. Tax disputes relating to non-discrimination obligations must therefore be resolved exclusively under the non-discrimination provision in the applicable tax treaty using the bilateral competent authority mechanism provided in the tax treaty. Access to the WTO Agreement dispute resolution procedures that provide for independent and binding dispute resolution is denied if the disputed matter falls within the “scope” of a tax treaty.

As a result of this provision there may be little scope to challenge a direct tax measure that relates to the national treatment obligation under the GATS as discriminatory. In contrast, a direct tax measure that violates the MFN obligation may, subject to a specific tax treaty exception, form the subject matter of a potential complaint under the GATS.

27. Ibid., Art. XXII (3).
28. Stahl, supra note 4. Discrimination in direct tax matters became a major issue in the final days of negotiating the WTO Agreement in the Uruguay Round. The U.S. strongly opposed the inclusion of direct taxes in the national treatment requirements under the GATS. The inclusion would have resulted in multilateral discipline on governments that would not provide national treatment to foreign service providers. It was the view of the U.S. that such matters should be resolved solely under the bilateral double taxation agreements, that is, through the bilateral competent authority procedure. Some 113 countries disagreed with the U.S. position.
29. GATS, supra note 3, Art. XXII (3).
30. Ibid. This step alone was apparently not considered sufficient to restrict discipline over direct tax matters to a tax treaty. A footnote to Article XXII (3) of the GATS further provides that if there is a disagreement about whether the matter falls within the scope of a tax treaty and the tax treaty was in existence at the time the WTO agreement entered into force, one country cannot unilaterally challenge the issue of the treaty’s scope under WTO procedures. Both parties to the existing tax treaty must consent if the WTO dispute resolution procedures (rather than the tax treaty procedures) are to be used. However, if future tax treaties are silent on the issue, either tax treaty partner may unilaterally bring a tax dispute based on the jurisdictional issue before the Council for Trade in Services, which may then refer the matter to binding arbitration.
31. A form of national treatment obligation is imposed under most tax treaties with respect to Citizens of a Contracting State who are residents of the other Contracting State. There appears to be little scope to challenge a tax that violates the national treatment obligation, at least under the GATS. At issue will be the precise scope of the non-discrimination article in the tax treaty. For example, as the NAFTA treaties only apply to Citizens or Nationals of a Contracting State who are residents of another Contracting State, can one argue that the national treatment obligation in the GATS applies with respect to those Citizens of a Contracting State who are not resident in the other Contracting State, or is the absence of a national treatment type of obligation in the tax treaty a complete answer to the question of whether the issue falls within the scope of a tax treaty? Unfortunately, even this question may have to be resolved under the Mutual Agreement procedure in the tax treaty. Article XXIII (3) of the GATS permits the matter to be referred to the Council for Trade in Services only with the consent of both parties if a tax treaty was in effect at the time the WTO Agreement came into effect.
2. The North American Free Trade Agreement (the NAFTA)

Chapter 12 of the NAFTA establishes basic rules agreed to by Canada, Mexico, and the U.S. for regulating the provision of services across their respective borders. The agreement calls for national treatment, MFN treatment, and prohibits local presence requirements. It exceeds the GATS both in scope and coverage, bringing all existing and future government measures relating to cross-border, non-financial services within the scope of the Chapter. Thus, unlike the GATS, where specific commitments to national treatment must be negotiated, the NAFTA operates in reverse, requiring each party to state explicitly—in various annexes—if it does not intend to conform to the general rules in Chapter 12 with respect to MFN, national treatment and other NAFTA obligations.

The principal provisions relating to the cross-border provision of service are contained in four chapters: Cross-Border Trade in Services, Telecommunications and Financial Services, Investment, and Temporary Entry for Businesspeople. Three annexes complement these chapters: Land Transportation, Professional Services, and Specific Reservations and Exceptions. Under the NAFTA, the cross-border provision of a service is defined as providing a service from the territory of one Party into the territory of another Party.

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32. NAFTA, supra note 2, Ch. 12. The NAFTA prohibition against requiring service providers to establish a presence (such as an office) within the territory of a NAFTA party as a condition of market access, eliminated many of the regulatory measures that cross-border service suppliers were formerly subject to when a local office was required.

33. Notwithstanding the limitations on the services protected, the general provisions of the GATS reflect the overall General Agreement on Tariffs and Trade (GATT) philosophy, thus the agreement contains a number of measures not found in the services provisions in NAFTA. For example, the GATS contains a safeguard limitation on services imports under a balance of the payments crisis (Article XII). Government procurement of services is also exempted from the MFN, national treatment and market access provisions (Article XII). Finally, the agreement commits Members to "enter into negotiations with a view to developing the necessary multilateral disciplines" to avoid the trade distortive effects of subsidies on trade in services. (Article XV).

34. These exceptions are provided in lieu of grandfather provisions. Annex I of the NAFTA contains the three countries' reservations schedules for their non-conforming federal measures. See NAFTA, supra note 2, Art. 1206(1)(a)(i). Laws and regulations that are grandfathered and listed as a reservation in Annex I cannot be challenged as long as they do not become more inconsistent with the agreement.

35. Ibid., Ch. 12.

36. Ibid., Ch. 13, 14.

37. Ibid., Ch. 11.

38. Ibid., Ch. 16. To facilitate access to other signatory countries, the NAFTA establishes the principle that business persons of one country who fall in any one of four categories: business visitors, traders and investors, intra-company transferees, and professionals will be granted temporary entry into the territory of the other countries. See NAFTA, ibid., Annex 1603.

39. Ibid., Annex 1212.

40. Ibid., Annex 1210.5.

41. Ibid., Annex 2106 (exempting Canadian Cultural Industries).
another Party; in the territory of one Party “by a person of that Party to a person of another Party,” and “by a national of a Party in the territory of another Party.” Unlike the GATS, in which the definition includes services provided by a service supplier of one Member through a commercial presence in the other, the NAFTA addresses this mode of supply through the Investment provisions in Chapter 11. A number of obligations from Chapter 12 (Services) are cross-referenced to the Investment Chapter.

The NAFTA requires that Parties accord to service providers of other Parties the better of national treatment and MFN treatment. Under the national treatment obligation, each party is obligated to treat foreign service providers no less favorably than it treats its own. States and provinces are also obligated to provide no less favorable treatment than the most favorable treatment accorded by the sub-national (that province) to the service providers of the country of which it forms a part. The MFN obligation ensures that service providers of other NAFTA parties in its territory are treated no less favorably than service providers of any other country in similar circumstances.

Overall, the NAFTA agreement is designed to significantly liberalize the trade in services by providing for common licensing rules, transparency provisions, dispute resolution procedures and an ongoing commitment to automatically include new services. The agreement, however, does not affect the respective income tax laws of each country or a country’s sovereign right to tax profits earned by non-residents within its borders. Therefore, although many non-tariff barriers may be reduced or eliminated under the NAFTA, the issue of direct taxation also remains largely undisciplined under this agreement.

a. Taxation

Although it may not generally discipline direct tax matters, the NAFTA, like the GATS, specifically addresses the issue of taxation. The principal provisions that relate to taxation are contained in Article 2103, which

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42 See definition of “cross-border provision of a service” in the NAFTA, ibid., Art. 1213.
43 Ibid., Art. 1204.
44 Ibid., Art. 1202.
46 Ibid., Annex 1210.5(1). The NAFTA also committed to encourage professional bodies to develop mutually acceptable standards for licensing professionals and reciprocal recognition of each other’s professional accreditations. This was an important step in eliminating a significant non-tariff barrier to free trade in services. Unfortunately there is no time limit on this process under the NAFTA, although some progress has been made with respect to the engineering profession and foreign legal consultants. The NAFTA also requires the parties to fairly review and answer applications by the NAFTA party nationals for professional licensing.
47 Ibid., Art. 1207, 1209.
begins by announcing that nothing in the NAFTA will apply to any tax measure except as specifically provided for in Article 2103(1).

The first matter to be clarified in the NAFTA is the status of tax treaties entered into by the NAFTA signatories. In general, these are to have priority in all cases, including when a treaty is inconsistent with the NAFTA agreement.\textsuperscript{49} As a result, the NAFTA, like the GATS requires that disputes regarding tax matters covered by a tax treaty be resolved exclusively under the applicable tax treaty provisions.\textsuperscript{50}

There are two exceptions to the primacy of tax treaties in tax matters specifically listed in the NAFTA. The first is with respect to the national treatment obligation as it relates to the trade in goods. The national treatment obligation, as proscribed in Article III of the GATT will have primacy over lesser obligations assumed under a tax treaty.\textsuperscript{51} The second exception concerns export taxes; specifically, Article 314, which allows Mexico to impose an export tax on basic foodstuffs and Article 604, which addresses the imposition of export taxes on energy in defined circumstances. These exceptions may be of little practical effect, as such matters are not normally addressed in a tax treaty.\textsuperscript{52}

Article 2103 of the NAFTA identifies three other areas where the Agreement may apply to tax matters including: income and capital tax measures affecting the purchase or consumption of cross-border and financial services; other taxes affecting services and investments; and tax measures linked to performance requirements.\textsuperscript{53} These provisions are discussed below.

\textsuperscript{49} It has been suggested that in the case of parallel rights and obligations under a tax treaty and the NAFTA, only the tax treaty's procedural provisions with respect to such rights and obligations shall be used. See U.S., Department of Homeland Security, \textit{House Ways and Means Committee Report}, (H.R. Rep. No. 3450, 511 - Discriminatory Taxes), online: U.S. Customs & Border Protection <http://www.customs.gov/nafta/nafta095.html>.

\textsuperscript{50} \textit{NAFTA, supra note 2 Art. 2103(2).}

\textsuperscript{51} See e.g., \textit{NAFTA, ibid., Art. 2103(3)(a) which provides that Article 301 applies to taxation measures to the same extent that Article III of the GATT would apply and therefore allows access to the NAFTA dispute settlement procedures in alleging discrimination with respect to imported goods.}

\textsuperscript{52} But see discussion in Part III: Tax Discrimination: Some Examples.

\textsuperscript{53} In addition, \textit{NAFTA, supra note 2 Art. 2103(6) provides that Article 1110 (Expropriation and Compensation) shall apply to taxation measures subject to certain procedural rules. The NAFTA, ibid., Art. 2103(6) states that the expropriation provisions of Article 1110 apply to taxation measures. A taxation measure alleged to be expropriatory must be referred by the investor to the appropriate competent authorities under the relevant tax convention at the same time that it gives notice under Article 1119. If such competent authorities determine that the measure is not an expropriation, the Article 1110 cannot be invoked by the investor as the basis for a claim under Articles 1116 or 1117. However, the investor may submit its claim to arbitration if the competent authorities do not agree to consider the issue or cannot agree that the measure is not an expropriation within a six-month period commencing at the time of referral to the competent authorities.}
b. Services

Taxes on trade in cross-border services and financial services are protected to a limited extent by the NAFTA’s national treatment provisions. Article 2103(4)(a) states that, subject to any applicable tax treaty, the national treatment clause “shall apply to all taxation measures on income, capital gains or the taxable capital of corporations, and to ... [the asset tax under the Asset Tax Law of Mexico, to the extent that those taxes] relate to the purchase or consumption of particular services.” This provision would presumably prevent a NAFTA country’s income tax law, for example, from allowing the deduction of consulting services purchased from a domestic consulting firm but not from firms in other NAFTA countries.

Article 2103(4)(b) further clarifies that the national treatment and MFN obligations contained in the investment, cross-border and financial services chapters apply to all taxation measures other than those on income, capital, estates, gifts, inheritances and generation-skipping transfers. The result is that both an MFN and national treatment obligation extend to taxes such as excise tax, provincial and state sales tax and, in Canada’s case, the Goods & Services Tax (GST).

Although the obligation assumed under Article 2103(4) of the NAFTA may appear broad in scope, the tax measures subject to discipline under the NAFTA are limited by a number of important exceptions. The first exception relates to tax treaty partners. As stated, any applicable tax treaty overrides the national treatment obligation under the NAFTA. Further, obligations assumed under the MFN provisions in the NAFTA do not prevent a NAFTA government from providing an exclusive bilateral advantage under a tax treaty to a specific treaty partner.

Second, the NAFTA provisions do not apply to any taxation measures in existence at the time that NAFTA came into effect (1 January 1994) or to the renewal or any amendment of a tax measure that does not decrease

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54. Ibid., Art. 2103(4)(a). Specifically, in relation to direct taxes, subparagraph 4(a) provides that certain direct tax measures listed therein (taxes on income, capital gains or the taxable capital of corporations and the Mexican asset tax) are but for listed limitations, subject to the national treatment obligation with respect to the cross-border provision of services, including financial services. However, with regard to financial services, subparagraph 4(a) applies only to the cross-border provision of a financial service under Article 1405(3).


56. NAFTA, supra note 2, Art. 2103(4)(b). The Canada-U.S. Treaty also extends the non-discrimination provisions to federal sales and excise tax, including in the case of Canada, the Goods and Services Tax, see Canada-U.S. Treaty, supra note 6, Art. 25(10). This would give the tax treaty priority in a dispute related to such federal taxes.

57. NAFTA, supra note 2, Art. 2103(4) (c-h).


59. NAFTA, supra note 2, Art. 2103(4)(d).
its conformity. This will allow existing tax measures to remain in place indefinitely even if they are inconsistent with the national treatment or MFN obligations in the NAFTA with respect to cross-border services and investments.

Third, similar to the GATS, a widely drafted exclusion clause has been added for "any new taxation measure aimed at ensuring the equitable and effective imposition or collection of taxes and that does not arbitrarily discriminate between persons, goods or services of the Parties or arbitrarily nullify or impair benefits accorded under those Articles...." Thus, measures adopted by a Party that are directed at tax avoidance or abuse with respect to taxes described above and levied by that Party will be considered taxation measures imposed in accordance with the exception described above. Such measures would include, for example, provisions relating to the proper characterization of payments between related parties and provisions for the determination of income and expenses in transactions between related parties.

c. Performance Requirements

The two remaining NAFTA tax measures described in Article 2103 of the NAFTA are found in Chapter I1, the investment chapter, and relate to performance requirements linked to taxation measures. Chapter I1 of the NAFTA contains prohibitions that prevent NAFTA governments from imposing certain conditions on the "establishment, acquisition, expansion, management, conduct, operation or sale" of an investment of an investor of a Party or of a non-Party in its territory. Article 1106(1) prohibits seven different types of practices, including: achieving a given level or percentage of domestic content; purchasing, using or according a preference to goods produced or services provided in its territory, or

60. Ibid., Art. 2103(4)(g).
61. Ibid., Art. 2103, Ch. 11.

Under Article 1106, a government may not, as a condition for the establishment or operation of an investment, require a firm to:

- limit its sales in the domestic market by conditioning such sales on exports or foreign exchange earnings;
- buy or use components from a local supplier or accord a preference to domestic goods or services;
- achieve a minimum level of "domestic content";
- limit its imports to a certain percentage of exports or foreign exchange inflows associated with the investment;
- transfer technology to any domestic entity, except to remedy an alleged violation of competition law;
- export a specified level of goods or services; or
- supply designated regional or world markets solely from its local production.
purchasing goods or services from persons in its territory. Article 1106(1)
also establishes a general prohibition on all requirements, commitments
or undertakings upon an investor to use goods or services provided in its
territory.\textsuperscript{63} Thus government actions that commit an investor to use local
goods or services constitute a clear violation of the NAFTA.

In addition to the general prohibition on performance requirements
established in Article 1106(1), the NAFTA contains a special reference
to prohibitions on performance requirements made in connection with
the conferral of benefits by a government. Such benefits would include
subsidies, financing assistance and tax concessions. Specifically, NAFTA
Article 1106(3) provides that

\textit{No Party may condition the receipt or continued receipt of an advantage,
in connection with an investment in its territory of an investor of a Party or
of a non-Party, on compliance with any of the following requirements:

(a) to achieve a given level or percentage of domestic content;
(b) to purchase, use or accord a preference to goods produced in its
territory, or to purchase goods from producers in its territory;
(c) to relate in any way the volume or value of imports to the volume or
value of exports. [or goods and services while Article 1106(3) only
applies to goods];
(d) to restrict sales of goods or services in its territory ... by relating
such sales in any way to the volume or value of its exports or foreign
exchange earnings.}\textsuperscript{64}

Article 2103(5) has incorporated these performance prohibitions into the
NAFTA tax provisions meaning that subject to an applicable tax treaty,
the prohibitions shall also apply to tax measures. As a result a government
is prohibited from tying a tax advantage, such as a tax holiday, “to the
purchase of locally produced goods or the manufacture of goods with a
certain level of domestic content.”\textsuperscript{65}

Notwithstanding, Article 1106(4) provides that a Party is not prohibited
from “conditioning an advantage, in connection with an investment in
its territory of an investor, or compliance with a requirement to locate
production, provide a service, train or employ workers, construct or
expand particular facilities or carry out research and development in its
territory.”\textsuperscript{66} Thus, a party may condition the receipt of a tax advantage
on the performance of services in its territory. It follows that a NAFTA
government may also condition the receipt or continued receipt of a tax

\textsuperscript{63} \textit{NAFTA}, supra note 2, Art. 1106(1) (c).
\textsuperscript{64} \textit{Ibid.}, Art. 1106(3).
\textsuperscript{65} \textit{NAFTA}, Article 2103(4) requires national treatment in these circumstances.
\textsuperscript{66} \textit{NAFTA}, supra note 2, Art. 1106(4).
benefit in connection with the purchase of services on the requirement that the service be provided in its territory.\textsuperscript{67}

These may prove important exceptions in the obligation to provide national treatment to foreign service providers. In particular, these exceptions may prove significant when one considers the tax advantages currently available in Canada with respect to investment tax credits, including scientific research and experimental development tax credits.\textsuperscript{68}

In summary, discipline with respect to the imposition of income tax under the NAFTA has been delegated by very specific wording in the NAFTA, to the bilateral tax treaties. However, the NAFTA, and in particular the national treatment obligation under the NAFTA, may apply to matters not covered in a tax treaty, subject to the proviso that nothing in the NAFTA shall affect the rights and obligations of any Party under a tax treaty. This may occur more frequently than one might expect. For example, the non-discrimination article in a tax treaty may not address certain aspects of discrimination against foreign service providers resulting from a Party's grant of a tax relief or a reduction in income tax to consumers of that service. To the extent that such discrimination is not addressed in a tax treaty, it will be subject to the national treatment obligation in the NAFTA.\textsuperscript{69} Similarly, none of the tax treaties between Canada and the other NAFTA parties bind states, provinces, or local authorities with respect to the taxes they choose to impose. Despite the existence of a tax treaty between Canada and another NAFTA party, an income tax imposed by a province of Canada (or a state of the U.S. or of Mexico) in violation of the national treatment obligation would, to the extent that such obligations are binding on states or provinces,\textsuperscript{70} be subject to the NAFTA, assuming the tax was neither permitted under a grandfather clause,\textsuperscript{71} nor allowed as an "equitable and effective imposition or collection of taxes."\textsuperscript{72}


\textsuperscript{68} \textit{Income Tax Act, R.S.C. 1985 (5th Supp.), c. 1. ss. 127(5)-(35) [ITA].}

\textsuperscript{69} At issue will be whether the absence of a national treatment obligation under the tax treaty provides the complete answer to the question of whether national treatment is required. See Example 4 and the discussion infra note 124.

\textsuperscript{70} See \textit{NAFTA, supra note 2, Art. 105, which provides that "The Parties shall ensure that all necessary measures are taken in order to give effect to the provisions of the Agreement...by state and provincial governments."}

\textsuperscript{71} \textit{Ibid., Art. 2103(4)(c).}

\textsuperscript{72} \textit{Ibid., Art. 2103(4)(g), or otherwise excepted under the other exclusions in subparagraphs 2104(3)(3)-(f).}
II. The NAFTA Tax Treaties

As discipline over the direct taxation of cross-border service providers has largely been carved out of the MFN and national treatment protections provided under the GATS and the NAFTA, it follows that the tax treaties entered into between the U.S. and Canada, Mexico and Canada, and Mexico and the U.S. will assume considerable importance in preventing tax discrimination in the NAFTA bloc. The timing of the negotiation or, in the case of Canada and the U.S., the renegotiation of these tax treaties was doubtless not a coincidence.

Mexico entered into a bilateral tax treaty with both Canada\(^73\) (Mexico-Canada Treaty) and the U.S.\(^74\) (U.S.-Mexico Treaty) almost concurrently with the signing of NAFTA. Changes were also made to the Canada-U.S. Treaty to accommodate NAFTA\(^75\) in the form of a third protocol.\(^76\) These tax treaties, like the majority of tax treaties entered into globally, are based on the Model prepared by the Organization for Economic Co-Operation

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73. Mexico-Canada Treaty, supra note 6. The Mexico-Canada Treaty, entered into force 11 May 1992 and was the first bilateral tax treaty signed by Mexico. Like the Canada-U.S. Treaty, it is generally patterned on the OECD Model Treaty; however, in recognition of Mexico's status as a developing country, it also borrows from the United Nations' (U.N.) Model Treaty. The U.N. Model was designed to recognize and counter the fundamental imbalance in investment flow between developing and more developed treaty partners. The Canada-Mexico Treaty is currently under renegotiation. Text of the new treaty has been settled by the negotiators and is currently awaiting government approval in the two countries.

74. U.S.-Mexico Treaty, supra note 6. Following the negotiation of NAFTA by the U.S., Mexico and Canada, the tax treaty between the U.S. and Mexico, with a related protocol, was signed 18 September 1992. In 1995, a second protocol came into force expanding the scope of coverage of the exchange of information provision to include all taxes imposed by the Contracting States, including state and local taxes. The third protocol was signed 26 November 2002. The U.S.-Mexico Treaty also draws from the OECD Model Treaty and the U.N. Model Treaty. Therefore, although it follows the same general pattern as the Canada-U.S. Treaty, like the Mexico-Canada treaty, there are some significant differences in recognition of Mexico's developing country status.

75. Canada-U.S. Treaty, supra note 6. The current version of the Canada-U.S. Treaty was negotiated on the basis of the OECD Model Treaty. The treaty was signed in 1980 and has been the subject of four subsequent protocols, the latest signed in July 1997. The third protocol, signed in March 1995 includes numerous changes that appear to be in direct response to the NAFTA. The Canada-U.S. Treaty deviates from both the OECD and U.S. Model Treaties in a number of respects in order to take into account particular features of Canadian law, the unique economic relationship of Canada and the U.S., and the existing Canada-U.S. Treaty.

and Development (OECD Model Treaty). Both the Canada and U.S. tax treaties with Mexico also borrow from the United Nations’ Model Treaty. Notwithstanding these commonalities, all three NAFTA tax treaties vary to some extent to reflect the differences in tax systems and policy objectives of the three states concerned, the relative strengths and weaknesses of the treaty partners, matters of specific importance and trade-offs that the treaty partners are willing to make. Despite these differences, the OECD Model Treaty provides an appropriate framework to discuss the basic operation of tax treaty provisions. The specifics of the NAFTA tax treaties follow.

The OECD Model Treaty provides for the taxation of thirteen broad categories of income. These categories include income from real property, business profits, transportation, dividends, interest, royalties, gains from alienation, income earned from personal services and by artists and sportsmen, income from pensions and annuities, income from government services, payments to students, and other income. As the relevant treaty article(s) will determine whether the payment is subject to tax in the host country, an important threshold question will be whether the payment is

77. OECD Model Treaty, supra note 5. An important goal in treaty implementation is common interpretation and application of the treaty provisions. The Fiscal Committee of the OECD (Organization for Economic Cooperation and Development) produced the first draft Convention for Double Taxation in 1963. This was followed by major revisions to the OECD Model Treaty in 1977 and 1992 and it is expected that frequent updates will continue. Each revision is generally accompanied by explanatory commentary, that although not binding, is widely accepted as bearing great weight. Some have gone so far as to argue that by entering a treaty based on the OECD Model, the contracting parties intend that the treaty be interpreted in conformity with the commentary. Canada has recognized the importance of these commentaries when interpreting and applying tax treaties. See e.g. Crown Forest Industries Ltd. v. M.N.R., [1995] 2 S.C.R. 802.

78. United Nations “Convention Between (State A) and (State B) for Avoidance of Double Taxation with Respect to Taxes on Income [and on Capital].” A revised draft was adopted on May 7, 1999 and was finalized on January 11, 2001: U.N. Model Double Taxation Convention Between Developed and Developing Countries (Draft of 11 Jan 2001), 2001 WTD 116-41 (June 15, 2001) [U.N. Model]. Generally, Mexico preferred to follow the OECD Model, a model designed to establish a bilateral relationship between two developed or highly industrialized countries. In negotiations.

79. OECD Model Treaty, supra note 5. Tax treaties are intended to reduce or eliminate tax barriers to trade. Under the OECD Model Treaty, this is accomplished by apportioning taxing powers between signatories and requiring tax relief if double taxation occurs, based on these treaty rules. The OECD Model Treaty applies to all persons who are residents of one or both of the Contracting States. A “resident” is defined in Article 4 to include “any person who, under the law of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature.” The Treaty applies to tax on income and on capital, imposed on behalf of a Contracting State. In case of dispute on any matter that gives rise to taxation in a manner that is not in accordance with the terms of the OECD Model Treaty, there is a “mutual agreement procedure.” Under this procedure, the competent authorities agree to endeavor to arrive at a satisfactory solution if an objection made by a taxpayer of either country appears to be justified. The OECD Model Treaty also requires non-discrimination between nationals of the taxing state and nationals of the other Contracting State (or permanent establishments (PE’s) of enterprises of the other state), and makes provisions for the exchange of information.

80. See e.g. OECD Model Treaty, supra note 5, Art. 13, which addresses the tax treatment of capital gains (gains from the alienation of property).
for the provision of personal services or whether, for example, the payment represents business profits or royalties.81

1. **Article 14: Independent Personal Services**

In the case of income earned from the provision of services, the independent and dependent personal services articles in the NAFTA tax treaties are the main treaty articles that govern the tax treatment of services performed by non-residents. If payment is with respect to services provided by directors or senior managers, government service,82 services by artists and athletes83 or payment that affects students or apprentices,84 reference must be made to those treaty articles.

In theory, tax relief is provided under the independent personal services article so as not to discourage cross-border commerce through the interchange of independent professionals and other skilled personnel. Thus, in general, payments made with respect to independent personal services of an individual who is a resident of one Contracting State are not taxable in the other State unless that individual has or had a fixed base in the other State, and then are only taxable to the extent that services are performed in the other State and profits are attributable to that fixed base.85 As a result, under the Canada-U.S. Treaty, a U.S. resident who receives payment for personal services performed in Canada would not be taxable in Canada with respect to that income unless it was earned through a fixed base located in Canada.86

Article 14(1) of the U.S.-Mexico and Mexico-Canada treaties expand the circumstances under which the host country may tax the income earned by an independent service provider in the other Contracting State to

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81. In the past, a blurring has occurred between business profits, royalty income and income from personal services. Distinguishing a payment in respect of management or technical service fees, which may be exempt as business profit under Article 7, or as independent personal services under Article 14. from a royalty for the transfer of know how, which is potentially subject to a withholding tax under the royalty provisions has been a problem.
82. See e.g. Mexico-Canada Treaty, supra note 6, Art. 19.
83. Ibid, Art. 17.
84. Ibid, Art. 20.
85. OECD Model Treaty, Former Article 14, supra note 5. Article 14 was eliminated following a report entitled “Issues Related to Article 14 of the Model Tax Convention,” adopted by the Committee of Fiscal Affairs 27 January 2000. See Issues in International Taxation, No. 7 OECD 2000. The U.S. reserves the right to tax services performed by individuals present in the U.S. for more than 183 days during the year under the OECD Article. In that case the Treaty tie breaker rules in Article II must be referred to.
86. Notwithstanding the Canada-U.S. Treaty exemption, an American individual may be subject to Canadian withholding tax, Income Tax Regulations, C.R.C., c. 945, s. 105(1), requires a withholding of 15% on payments made to non-resident persons in respect of services rendered in Canada other than in the course of regular and continuous employment. Article 17 of the Canada-U.S. Treaty limits the amount to 10% of the first $5,000 made by each payer in a given taxable year based on the currency of the State where the services are performed.
include a time test. Specifically, an individual resident of one Contracting State, who derives income from the performance of personal services in the other State will avoid taxation in the other State only if the resident does not have a fixed place of business in the other Contracting State of which regular use is made in the course of performing activities, or is not present in the other Contracting State for a period or periods aggregating 183 days or more in a 12 month period. Assuming taxation is not avoided in the other Contracting State, tax may be imposed only on the income attributable to the fixed base or to the activities performed.

The potential difference in treatment of a cross-border service provider that results from the time test can be seen in Dudney v. R., a Canadian decision. Mr. Dudney, a U.S. citizen, performed services in Canada as an independent contractor in 1994 and 1995 on the premises of Pan Canadian in Calgary, training its employees. In total he spent 300 days in Canada in 1994, and about 40 days in 1995 working on the premises of Pan Canadian carrying on only those activities required under his contract. The court determined that based on these facts, Mr. Dudney did not have a fixed base

87. In the Mexico-Canada Treaty, supra note 6, Art. 14(1), the language is "unless he has regularly available a fixed base to him in the other Contracting State".

88. In accordance with the principles of Article 7 (Business Profits), the tax base is net of expenses incurred in earning the income. See U.S., Internal Revenue Service, Treasury Department, Treasury-Department Technical Explanation of the Convention Between the United States of America and Canada with respect to Taxes on Income and on Capital Signed at Washington September 26, 1980, as amended by the Protocol signed on March 28, 1984. Art. 14, online: Int'l TaxLaw.com <www.intltaxlaw.com/TREATIES/CANADA/Canada%tech%20explanation.pdf> (date accessed: 9 June 2005) [Treas. Tech. Explanation U.S. – Canada]. Point 14 of the Protocol extends Article 14 of the U.S.-Mexico Treaty to income derived by a resident U.S. company furnishing personal services through a fixed base in Mexico. In such a case, the company may compute the tax on the income from such services on a net basis as if that income were attributable to a permanent establishment in Mexico. In the converse case, the U.S. will apply Article 7 (Business Profits) directly. As under Mexican tax law a personal service company is not considered to earn business profits, such income must be taxed under Article 14. In Mexican law, there is a rebuttable presumption that when services are paid for by a resident of Mexico and were partly performed in Mexico, the entire payment is for services performed in Mexico. The taxpayer has the burden of proving that part of the services were performed outside of Mexico.

89. [2000] F.C.J. No. 230 (C.A.) [Dudney].

90. Ibid. at para. 7. The facts surrounding his work environment are very relevant. "The Appellant was at first provided with a small room from which to work. After three months he was moved to a larger room, which he shared with a number of other consultants. Later he was moved to another room in a different building, also occupied by PanCan. For the most part, the actual training, or mentoring, of the PanCan personnel took place in the offices of the people being trained, or in a conference room. Sometimes there would be meetings or consultations in the space provided to the trainers. Their use of that space was strictly limited, however. It was available to them for the purpose of the contract only. They could not conduct any other business from there, they could use the telephone only for business related to the PanCan contract, and their access to the building was controlled by a magnetic card system, and restricted to business hours, on week days only." Dudney, ibid. at para. 5.
in Canada, and therefore, under the Canada-U.S. Treaty, was not subject to tax in Canada on his income. In contrast, based on the time tests (183 days or more in any 12 month period), in the tax treaties between the U.S.-Mexico and Mexico-Canada, this result would be reversed; that is, Mr. Dudney would be subject to tax on this income in Mexico, if the services had been performed in Mexico. Similarly, if Mr. Dudney were a resident of Mexico who performed the services in Canada, he would be subject to tax in Canada on this income.

2. **Article 15: Dependent Personal Services**

Employees may also provide cross-border services. Assuming the services fall within the dependent personal service article (in contrast to, for example, Article 16 - Directors or Article 17 - Artist and Sportsmen), the following treaty provisions apply.

a. **Canada-U.S. Treaty**

Generally, the income of an employee will remain taxable in their country of residence unless the services are performed in the other country. Even when the employment is exercised in the other country, the right to tax remains with the country of residence provided that:

1. the employee earns less than $10,000 with respect to services performed in the other Contracting State; or
2. the employee is present in the other country less

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91. *Ibid.* The Judge made the following finding: "Where a person is denied the benefit of Article XIV on the basis that he has a fixed base regularly available to him in Canada, the question to be asked is whether the person carried on his business at that location during the relevant period. The factors to be taken into account would include the actual use made of the premises that are alleged to be his fixed base, whether and by what legal right the person exercised or could exercise control over the premises, and the degree to which the premises were objectively identified with the person's business. This is not intended to be an exhaustive list..."

92. OECD Model Treaty, *supra* note 5, Art. 15. Before 2000, the title of Article 15 of the OECD Model Treaty referred to "Dependent Personal Services" in contrast to Article 14, "Independent Personal Services". As a result of the elimination of Article 14 in the OECD Model Treaty, Article 15 was changed to "employment" - a term thought to more commonly describe the activities to which the Article applies.

93. Canada-U.S. Treaty, *supra* note 6, Art. 15. These exemptions do not apply to public entertainers (such as theatre, motion picture, radio or television artists, musicians or athletes) who derive more than US $15,000 in gross receipts for activities in the U.S. in a calendar year, see Canada-U.S. Treaty, *ibid.*, Art. 16.

94. OECD Model Treaty, *supra* note 5. According to the OECD commentary, "employment is exercised in the place where the employee is physically present when performing the activities for which the employment income is paid." OECD commentary on Article 15, 1 (added 23 October, 1997). This is so regardless of whether the results of the work are exploited in the other State.
than, in the aggregate, 183 days in that year and the remuneration is paid by or on behalf of an employer who is not a resident of the other country, and is not borne by a permanent establishment or a fixed base that the employer has in the other country.\footnote{Canada-U.S. Treaty, supra note 6, Art. 15. Article 15 refers to a presence in the other Contracting State "for a period or periods not exceeding in the aggregate 183 days in that year." Thus an employee could remain for periods in excess of 183 days by straddling two calendar years and still avoid host country taxation. The OECD Model Treaty has revised the language to eliminate this form of tax planning. The Model now refers to 183 days in any 12 month period. The commentaries also assist in calculation of the 183-day period. It is the OECD's position that a day of physical presence in the host country, including days of departure and arrival, sick days, and holidays should be included in the computation. The changes to the article were the result of a 1984 report entitled Organization for Economic Co-operation and Development, "Taxation Issues Relating to the International Hiring Out of Labour." Adopted by the OECD Council 24 August 1984, published in Trends In International Taxation (Paris: OECD, 1985).}

If a Canadian employee works in the U.S., Article 15 will result in U.S. taxation only when the employee is present in the U.S. for periods exceeding 183 days out of the year, or where the employment is exercised in the U.S. and the remuneration is "borne by" an employer who is a resident of the U.S. or by a permanent establishment or fixed base which the employer has in the U.S. and payment exceeds U.S. $10,000.\footnote{Canada-U.S. Treaty, supra note 6, Art. 15.}

b. \textit{U.S.-Mexico Treaty/Canada-Mexico Treaty}

Both the U.S.-Mexico and Canada-Mexico treaties follow the basic provisions of the OECD and Canada-U.S. treaties. Pursuant to Article 15(1), salaries, wages, and other similar remuneration are generally taxable only in the State of residence. However, as is the case with the Canada-U.S. Treaty, if the employment is exercised in the other Contracting State, such remuneration may be taxed in that other State if certain conditions are met. Under the U.S.-Mexico Treaty, if a taxpayer seeks to remain taxable solely in the country of residence (1) the recipient cannot be present in the other State for a period or periods exceeding 183 days in a 12 month period; (2) the remuneration cannot be paid by, or on behalf of, an employer who is

\footnote{Ibid., Art. 15(2)(b). The U.S. view is that "borne by" in this context means the wages or salary are deductible by the U.S. entity. Thus if a Canadian employed at the Canadian PE of a U.S. based company performs services in the U.S. and receives more than USD 10,000, that income is not exempt from U.S. tax. If a foreign employer pays the salary of an employee, but the host country or a permanent establishment reimburses the foreign employer and deducts the expense, the conditions for exemption, as the case may be, will not have been met. Treas. Tech. Explanation, Canada-U.S Treaty and IRS Tech. Adv. Mem. 8748003. The Canadian view, although similar, extends the notion of "borne by" an employer to include a determination of who directs the employee on a day-to-day basis rather than simply who pays the employee's salary.}

\footnote{See Canada-U.S. Treaty, supra note 6, Art. 15(3). A complete exemption from taxation in the other Contracting State is also provided in respect of an employment regularly exercised in more than one state on a ship, aircraft, motor vehicle or train operated by a resident of the other Contracting State.}
a resident of the other State; and (3) the remuneration cannot be borne by a permanent establishment or fixed base which the employer has in the other State.

Thus a U.S. resident who works in Mexico but is paid by a U.S. company with no permanent establishment in Mexico will not be taxable in Mexico unless the time limit of 183 days is exceeded. In contrast, a Mexican employee working in Canada for less than 183 days will be taxable in Canada under the Mexico-Canada Treaty once the remuneration earned exceeds $1,500 Canadian dollars (or its equivalent in Mexican pesos) "or such amount as may be specified and agreed in letters exchanged between the competent authorities of the Contracting States." 99 Mexican employees are also taxable in Canada if their stay exceeds 183 days in any 12-month period commencing or ending in the calendar year concerned, or if the wages or salaries are borne by an employer in Canada, or by a permanent establishment or a fixed base that the employer has in Canada.

If one examines the potential mobility of employees under the three treaties it becomes apparent that the most restrictive provisions apply to Canadians or Mexicans working in the other’s country. Host country taxation begins at CAD 1,500. The Canada-U.S. Treaty is more generous, imposing host country tax on employment income beginning at U.S. 10,000.

3. Article 16 – Directors’ Fees

Cross-border services may also be provided through the appointment of individuals to a Board of Directors in the other treaty country. Because the Canada-U.S. Treaty does not contain specific provisions addressing the taxation of Directors’ fees, such payments are subject to host country taxation under the general provisions of Article 15 (Dependent Personal Services). 100 As a result, if a U.S. resident sits on a Canadian Board, there will be no Canadian tax liability if the amount paid to that director is less than CAD 10,000 in a calendar year. 101

In contrast, Article 16 of the U.S.-Mexico Treaty applies specifically to Directors’ fees. It provides that directors’ fees and similar payments derived by a resident of a Contracting State for services performed outside

100. Canadian domestic law provides that the position of a corporate director is an office. Thus fees received by a director are characterized as office or employment income. See ITA, supra note 64, s. 248(1), for definitions of office, officer, employment and employee.
101. Ibid. Subject to Regulation 105 withholding tax obligations under the ITA, see Income Tax Act Regulations, C.R.C., c. 945, s. 105.
the State of residence, in the capacity of a director or overseer\textsuperscript{102} of a company that is a resident of the other Contracting State may be taxed in that other State.\textsuperscript{103} In consequence, Mexico is not permitted to tax fees paid by a Mexican company to its U.S. resident directors or overseers for their services, unless the services are performed outside of the U.S.

Article 16 of the Mexico-Canada Treaty is broader in scope than the U.S.-Mexico Treaty, and provides that a director's fees or remuneration, derived by a resident of a Contracting State in the resident's capacity as a Board member, or an official in a top-level managerial position of a company that is a resident of the other Contracting State may be taxed in the other State. This allows Mexico to tax the income earned by directors or senior management in Mexico, without the limitations imposed in the Dependent Personal Services Article and regardless of where the services are performed.

4. Article 24 – Non-Discrimination

One of the important protections provided by a tax treaty is protection against tax discrimination. Article 24 of the OECD Model Treaty contains provisions prohibiting discrimination against non-nationals or enterprises owned by non-residents. These obligations are, however, typically much narrower than the non-discrimination articles in trade agreements. Each of the NAFTA tax treaties also imposes obligations with respect to non-discrimination. The provisions vary widely both with respect to the obligations assumed by the treaty partners and the taxes covered under the tax treaty.

a. Canada-U.S. Treaty

Article 25 of the Canada-U.S Treaty imposes minimum obligations on the bilateral treaty partners with respect to discrimination in all taxes, and it applies to both individuals and business enterprises.

In the case of individuals, Article 25(1) establishes a prohibition similar to the national treatment obligation found in the trade agreements, against

\textsuperscript{102} U.S.-Mexico Treaty, supra note 6, Art. 16. The term "overseer" includes persons who are not directors but who oversee, or look out for, shareholders' interests without engaging in day-to-day management functions. Such a position is common in Mexican corporations.

discrimination against citizens of the U.S. or Canada who are resident in
the other's country. Specifically, citizens of one Contracting State cannot
be subjected to tax in the other Contracting State or any requirement
connected therewith that is "other or more burdensome than the taxation
and connected requirements to which citizens of that other State in the
same circumstances are or may be subjected." It is important to note
that a non-resident alien is not in the same circumstances as a resident
citizen, and that the Article does not prohibit discrimination against non-
residents.

There is also a type of MFN obligation. Specifically, individual citizens
of one State who are residents in the other State cannot be subjected to
taxation requirements that are more burdensome than those imposed on
similarly situated citizens of any third State (including State of residence).
As a result, a benefit available to a citizen in a third State that has a tax
treaty with Canada would also be available to a citizen living in that treaty
State. Thus, a Canadian citizen who is a resident of Mexico, but earning
income in the U.S., could avail themselves of any tax treaty benefits
available to a Mexican citizen living in Mexico and earning income in the
U.S. Special provisions are also included to deal with married individuals
and with dependent deductions.

In the case of business ventures, a national treatment obligation
provides limited protection against tax discrimination. Specifically, a
permanent establishment or fixed base located in the other Contracting
State cannot be taxed less favourably than an enterprise of that State
carrying on the same activities. There is also an obligation to provide
da deduction for interest, royalties and other disbursements paid by an
enterprise of one State to a resident of the other; such amounts should
be a deduction for interest, royalties and other disbursements paid by an
enterprise of one State to a resident of the other; such amounts should be

104 Canada-U.S. Treaty, supra note 6, Art. 25(1). Note that the provision does not prohibit
discrimination against non-residents, only discrimination based on citizens of one Contracting State
who are resident in the other Contracting State.
105 Ibid.
106 Ibid.
107 Ibid., Art. 25(2).
108 Ibid., Arts. s. 25(3), (4).
109 Ibid., Art. 25(6). Notwithstanding this general obligation, there is no obligation to provide
national treatment with respect to personal allowances or relief on account of civil or family matters
on dividend treatment. The non-discrimination article is also silent on the issue of fixed bases.
Notwithstanding, it would appear an individual subject to the independent personal services article of
the treaty with a fixed base in the Contracting State can rely on the same principles, see Treas. Tech.
Explanation, supra note 84, Art. 25(6).
deductible in calculating taxable profits under the same conditions as those
paid to a resident of the same State.\textsuperscript{110}

Although Article 25 provides for national treatment of permanent
establishments and fixed bases, this protection is denied to foreign
controlled corporations resident in Canada. Instead, only MFN treatment
is accorded to companies owned or controlled (wholly or partly) by
residents of the other Contracting State with respect to taxation and related
requirements.\textsuperscript{111}

A somewhat unusual provision in Article 25(9) of the Canada-U.S.
Treaty also allows for the deduction of convention or meeting expenses
if the function is to be held in the other Contracting State. This provision
was apparently considered necessary due to a prohibition in U.S. domestic
law against the deduction of convention expenses where the event is held
outside the country.\textsuperscript{112}

Despite Article 11 of the Canada-U.S. Treaty, which limits the taxes
covered in the case of Canada to taxes imposed under the Canadian Income
Tax Act. Article 25(10) extends the obligation of non-discrimination to “all
taxes imposed by a Contracting State.” In Canada, this would include the
GST, but not provincial or local taxes. To the extent that such provincial
or local taxes are considered discriminatory, resort to the NAFTA or the
WTO procedures would be permitted because the matter is not addressed
in a tax treaty. Whether or not a remedy would be available under
either trade agreement would depend on whether the disputed tax falls
within the specific carve-outs from MFN and national treatment in those
agreements.

b. U.S.-Mexico and Mexico-Canada Treaties
Both the Canada and U.S. tax treaties provide that nationals of a Contracting
State may not be subjected, in the other Contracting State, to any taxation
or connected requirements that are more burdensome than the taxation
or connected requirements to which the nationals in the other State are

\textsuperscript{110} Canada-U.S. Treaty, supra note 6, Art. 25(7), (8). Art. 25(8) permits thin capitalization rules, a
clear departure from the national treatment obligation.

\textsuperscript{111} Ibid., Art. 25(5). This non-discrimination provision is not as broad as that normally sought by
the U.S., or as contained in the OECD Model Treaty as it provides MFN treatment, but not national
treatment to foreign controlled corporations. The most obvious example of the limitations of the article
is the small business tax credit that is available under the Canadian ITA exclusively to Canadian
controlled private corporations, and is therefore unavailable to U.S. subsidiaries. A number of other
important tax concessions are also available only to Canadian taxpayers. The tax treaty also provides
only MFN treatment to citizens of one State that are not resident in the other. As previously discussed,
all discrimination matters falling within the scope of the tax treaty must be resolved under the Treaty.

\textsuperscript{112} See Treas. Tech. Explanation, U.S.-Canada, supra note 84, Art. 25(9). This provision was
subsequently amended to permit the deduction of meeting expenses if held in North America.
subjected in the same circumstances. A national of a Contracting State is afforded the same protection even if the national is not a resident of either Contracting State. Similarly, under paragraph (2), a permanent establishment or fixed base in a Contracting State of a resident of the other Contracting State cannot be taxed less favorably in that Contracting State than an enterprise of a resident of the Contracting State carrying on the same business.

This obligation extends, in the case of the U.S.-Mexico Treaty, to all taxes imposed by a Contracting State, political subdivision or local authority. The Mexico-Canada Treaty, in contrast, applies only to income taxes imposed by the governments of Canada and Mexico (including the Assets Tax Law in the case of Mexico), but does not apply to any other tax. This means, for example, that a dispute about whether the imposition of a discriminatory GST tax on the purchase of services is in violation of the national treatment obligation could be initiated by Mexico under the NAFTA, as the matter does not fall under the Canada-Mexico Treaty.

Other differences exist within the non-discrimination provisions of the NAFTA tax treaties. For example, unlike the Canada-U.S. Treaty, Article 25(5) of the U.S.-Mexico Treaty requires that a Contracting State not impose other or more burdensome taxation or connected requirements on a company that is a resident of that State but that is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State. Thus national treatment rather than MFN treatment is provided to foreign corporations resident in the other Contracting State.

In summary, the scope of the non-discrimination provision in the U.S.-Mexico Treaty is much broader than the Canada-U.S. Treaty and the Mexico-Canada Treaty, both with respect to the taxes covered by the

113 Neither Contracting State is required to provide to a resident of the other Contracting State the same personal exemptions and deductions that it provides to its own residents to take account of marital status or family responsibilities. Article 25(4) prohibits discrimination in the allowance of deductions. See U.S.-Mexico Treaty, supra note 6, Art. 25(4).

114 Thus, a U.S. citizen who is a resident in a third country is entitled to the same tax treatment in Mexico as a Mexican national receives in that third country. Treas. Tech. Explanation U.S.-Mexico, supra note 103.

115 I.R.C. §1446 imposes on any partnership with income, which is effectively connected with a U.S. trade or business the obligation to withhold tax on amounts allocable to a foreign partner, see I.R.C. §1446 (2002). This obligation applies with respect to a Mexican resident partner's share of the partnership income attributable to a U.S. permanent establishment. There is no similar obligation with respect to the distributive shares of a U.S. resident. It is understood that distinction is not a form of discrimination within the meaning of paragraph (1) and (2) of Article 25, see Treas. Tech. Explanation U.S.-Mexico, supra note 103, Art. 25. U.S.-Mex. Article 25(3) provides that nothing in this Article will prevent either Contracting State from imposing the branch taxes described in Article 11A (Branch Tax) or prevent Mexico from denying a deduction for presumed expenses related to income from real property to a U.S. resident who elects to deduct actual expenses in computing the Mexican tax on such income, as provided in Article 6(5) (Income from Immovable Property (Real Property)).
treaty and the persons who impose them. That tax treaty will therefore have primacy in a much broader range of circumstances. One result of this will be that recourse to the NAFTA and the WTO dispute resolution procedures will be more limited under the U.S.-Mexico Treaty.

The following table provides a summary of the taxes covered and the non-discrimination articles in each of the NAFTA tax treaties.

*Table 1: Summary of Provisions Included in the Non-Discrimination Articles in the NAFTA Treaties*

<table>
<thead>
<tr>
<th>Canada-U.S.</th>
<th>Mexico-Canada</th>
<th>U.S.-Mexico</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Individuals</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Citizens who are residents of the other Contracting State shall not be subjected in that other State, to any taxation requirement that is other or more burdensome than the taxation and connected requirements to which citizens in the same circumstances are or may be subjected.</td>
<td>Nationals shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. EXCEPT with respect to any personal allowances, relief and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.</td>
<td>Nationals shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. EXCEPT with respect to any personal allowances, relief and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.</td>
</tr>
<tr>
<td>Citizens who are NOT residents shall not be subjected to any taxation requirement that is other or more burdensome than the taxation requirements to which citizens of any third state in the same circumstances (including state of residence) are or may be subjected.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Permanent establishment (&quot;PE&quot;) and fixed bases (&quot;FBs&quot;)</td>
<td>Canada-U.S.</td>
<td>Mexico-Canada</td>
</tr>
<tr>
<td>--------------------------------------------------</td>
<td>-------------</td>
<td>---------------</td>
</tr>
<tr>
<td>The taxation on a PE which a resident holds in the other Contracting State shall not be less favourably levied in the other State than the taxation levied on residents of the other Contracting State carrying on the same activity.</td>
<td>NT-taxation ...shall not be less favourably levied in that other State than the taxation levied on residents of that other State carrying on the same activities.</td>
<td>NT-taxation ...shall not be less favourably levied in that other State than the taxation levied on residents of that other State carrying on the same activities.</td>
</tr>
<tr>
<td>Companies</td>
<td>MFN</td>
<td>MFN</td>
</tr>
<tr>
<td>Deductibility of Expenses</td>
<td>Interest, royalties and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profit of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.</td>
<td>NA</td>
</tr>
</tbody>
</table>
5. Mutual Agreement Procedure

Each of the three NAFTA treaties include a mutual agreement procedure which provides generally that the competent authorities of the Parties are to resolve, by mutual agreement, any difficulties or uncertainty with respect to the interpretation or application of the tax conventions. An important issue that will have to be resolved with respect to the application of the tax treaty to both NAFTA, and in respect of the MFN obligation in the WTO, is whether this procedure is intended to pre-empt a challenge under a trade agreement, based on an argument that the competent authorities designated under the tax treaty should be the ones who determine whether the tax convention is to prevail.

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116. See e.g. Canada-U.S. Treaty, supra note 6, Art. 26:2 b.
117. The following is from the U.S. Cong. Rec., S16108(1993), excerpts on Sec. 511 Discriminatory Tax: "...the Committee understands that procedures may be initiated under NAFTA Article 2007 only if the consulting competent authorities agree that, with respect to the measure, the tax convention does not prevail over the NAFTA in accordance with paragraph 2 of Article 2103. With regard to other taxes, if, within three months after the issue of whether the tax convention prevails is brought to the attention of the competent authorities, the consulting competent authorities do not agree to consider the issue or, having agreed to consider it, fail to agree within six additional months whether the tax convention prevails over NAFTA, the committee anticipates that procedures may be instituted under NAFTA Article 2007. The Committee understands that the time periods set out above may be altered in any particular case by mutual agreement of the consulting competent authorities." See online: U.S. Customs & Border Protection <http://www.customs.gov/nafta/nafta095.htm>.
118. Ibid.
III. Tax Discrimination: Some Examples

Disputes will inevitably arise with respect to the treatment of cross-border service providers under either the GATS or Chapter 12 of the NAFTA. If a dispute occurs in circumstances in which both the WTO agreement and the NAFTA may apply, the NAFTA sets out the choice of forum rules for resolving the dispute. In general, the choice is up to the complaining party. If the dispute arises in respect of a tax matter, additional considerations apply.

As discussed, both the WTO and the NAFTA provide for the primacy of tax treaties in tax matters. However, each of the trade agreements and the tax treaties address the matter of discrimination differently. Each tax treaty is unique in two important ways: first, in what taxes are covered by the treaty; and second, how the non-discrimination article is to be interpreted.


120. However, dispute settlement proceedings initiated under the NAFTA or the WTO Agreement preclude the initiation of proceedings under the other forum. The ability to choose the forum for dispute resolution clearly provides an advantage to the complaining party, who will obviously choose a forum with rules most favorable to the success of its case. The U.S., for example, pursued its case against Canadian policies in respect of periodicals (the Sports Illustrated dispute) through the WTO rather than NAFTA because, unlike NAFTA, the WTO Agreement does not contain an exception for cultural matters. Conversely, Canada, which had little success in avoiding the imposition of countervailing and dumping duties for softwood lumber under the NAFTA, chose to argue its case before the WTO where it could rely on the GATT Subsidies Code rather than U.S. domestic law for a finding of whether there was in fact a subsidy. Given that the parties in the NAFTA bloc have assumed more extensive obligations with respect to the cross-border trade in services under NAFTA, it is likely that it will more often be the preferred forum for dispute resolution. If the dispute relates to a tax matter, reference must be made to the applicable tax treaty, as both the GATS and the NAFTA specify that bilateral tax treaties take precedence in all but very limited exceptions with respect to matters covered in the applicable tax treaty.
Tax Discrimination in the NAFTA Bloc

and applied. Thus, if tax discrimination is alleged, both the question of whether a tax treaty applies, and if not, whether obligations under either the NAFTA or the WTO have been violated, must be addressed before a determination can be made that the tax is discriminatory. An additional question will be what is the appropriate forum for dispute resolution—the NAFTA or the WTO.

An application of these guidelines yields some surprising results, particularly when one considers the national treatment and MFN obligation assumed by Canada, the U.S. and Mexico under the NAFTA and WTO agreements. Consider the following examples.

1. Example One

The Canadian government imposes an income tax on $2,000 of employment income earned in Canada by a Mexican truck driver, paid by

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121. For example, in the case of the Canada-U.S. Treaty, the tax treaty itself addresses the potential role of the WTO in resolving tax matters. Specifically, the Third Protocol amends Article 29 of the tax treaty to include new provisions for purposes of the application of Article 22 (3) of the GATS and the national treatment obligation. The amendment provides that for the purposes of the NT obligation, in the GATS, Canada and the U.S. agree that a tax measure will fall under the tax treaty if it relates to a tax to which Article 25 (non-discrimination) applies or, if it does not relate to non-discrimination, it falls within another tax treaty provision, but only to the extent that the measure relates to a matter dealt with in that tax treaty provision. The tax treaty also clarifies that notwithstanding Article 22 of the GATS, any doubt as to the interpretation of the scope of a treaty provision, and specifically whether the tax treaty applies, will be resolved under the Mutual Agreement procedure of the tax treaty. In the case of the U.S. tax treaty with Mexico, a Third Protocol was signed on 26 November 2002 to further clarify the primacy of the tax treaty. This protocol is very explicit and far-reaching. Paragraph 3(b) provides that no other agreement to which the U.S. and Mexico are parties shall apply with respect to taxation measures unless the competent authorities agree that the measure is not within the scope of the non-discrimination provisions of Article 25 of the U.S.-Mexico Treaty. Accordingly, if the non-discrimination article in the tax treaty applies to a taxation measure, no national treatment or MFN obligations undertaken by the Contracting States in any other agreement shall apply to that taxation measure. The Mexico-Canada Treaty was in existence prior to the entry into force of the GATS. In consequence, although the treaty is silent about the role of the GATS, according to the GATS understanding, the non-discrimination article in that tax treaty will have primacy over the GATS national treatment obligations. As well, the parties will be subject to the GATS requirement that both parties must consent to have the issue of the treaties scope settled by the Council for Trade in Services.

122. To reach a conclusion about whether a tax is discriminatory, and if so, how it is to be disciplined, a series of questions could be posed. These might include:

1. What is the tax issue being complained about?
2. Does a tax treaty apply?
   - If the answer is yes, the tax treaty prevails.
   - If the answer is maybe, the competent authority will decide if the tax treaty applies to the matter with respect to the national treatment obligation under the GATS. With respect to other issues consider the role of the relevant Mutual Agreement Procedure.
   - If the answer is no, see step 3.
3. If the answer to (2) is no, which of the WTO Agreement (GATS) or NAFTA applies? If the answer is either, which is the forum from the complainant's perspective for dispute settlement?
The driver is in Canada for approximately six weeks each summer. The tax would not be imposed on $2,000 of employment income earned by a driver from the U.S. in similar circumstances. Can the Mexican government complain that tax discrimination has occurred? The answer is no. Both the NAFTA and the GATS provide for the primacy of tax treaties.

Pursuant to Article 15(2) of the Mexico-Canada Treaty, a resident of Mexico can earn income from employment exercised in Canada without paying Canadian tax, as long as the employee is present in Canada in the aggregate for less than 183 days in any twelve month period commencing or ending in the calendar year concerned and either the salary or wages are paid by or on behalf of a Mexican resident (i.e. the trucking company) that does not carry on business in Canada through a permanent establishment, or if the remuneration earned in Canada totals less than CDN $1,500 in the calendar year concerned.

In this case the employment income earned in Canada exceeds the $1,500 threshold, and the driver is, therefore, not exempt under the tax treaty. In the case of remuneration earned by the U.S. trucking employee in Canada, the exemption from Canadian taxation is $10,000.

In the above example, assume a U.S. driver is employed by a U.S. resident corporation and makes frequent trips across the Canada-U.S. border, resulting in a total stay in Canada that exceeds the 183 day exemption allowed under the Canada-U.S. Treaty. His exemption from Canadian tax remains straightforward. Pursuant to Article 15(3) of the Canada-U.S. Treaty, remuneration derived by a resident of the U.S. in respect to an employment regularly exercised in more than one State (i.e. country) on a ship, aircraft, motor vehicle or train operated by a resident of the U.S. is taxable only in the U.S. Thus, the employment income would not be taxable in Canada. The same is not true of a Mexican driver in similar circumstances. Under the Canada-Mexico Treaty, remuneration in respect of employment exercised in the other Contracting State is exempt only if exercised aboard a ship or aircraft in international traffic. There is no exemption for employment exercised aboard a motor vehicle or train to parallel the exemption found in the Canada-U.S. Treaty.

2. Example Two
Mexicorps Conventions Inc. (Mexicorp) organizes conventions, meetings and other such events at its facility in Guadalajara. Mexicorp's bid to host the next annual meeting of U.S. Corp., a large U.S. corporation has been met with stiff resistance by U.S. Corp, who states a clear preference for holding it's meeting in Banff, Alberta as the costs of the meeting, if held in Banff, are fully deductible, but will not be deductible. The problem, it
Tax Discrimination in the NAFTA Bloc

appears, is a restriction in the U.S. Revenue Code on the deductibility of expenses incurred for foreign conventions.\textsuperscript{123}

Can it be argued that the U.S. has violated its MFN obligation under the WTO by refusing to permit the deduction of meeting expenses if the convention is held in Guadalajara because the matter is covered by the terms of a tax treaty? Specifically, Article 24(9) of the Canada-U.S. Treaty provides for the deduction of convention expenses to the same extent that such expenses would be deductible if the convention were held in the U.S. Because the WTO expressly permits the violation of the MFN obligation if the matter is addressed in a tax treaty, there is no basis for complaint by Mexico, at least with respect to a violation of the MFN obligation.\textsuperscript{124}

What if there was not a specific exemption in the Canada-U.S. tax treaty with respect to the deductibility of convention expenses? Can Mexico argue that the U.S. has violated its MFN obligation under either the WTO or the NAFTA? It would appear that the MFN obligation in the GATS has been violated if the difference in treatment is not the result of a tax treaty or other tax agreement. In contrast, under the NAFTA, the answer would appear to be no, as Article 2103(1) provides that nothing in the NAFTA “shall apply to tax measures except as set out in the NAFTA.” There is no MFN obligation in the NAFTA with respect to direct taxation (income taxes).

3. Example Three

Catherine, a Canadian, and Ursula, an American, are both on the Board of Directors of Mexicorp. Each receives the equivalent of $50,000 U.S. per annum for their services. Directors’ meetings, which are held quarterly, are generally held by video conferencing, with Catherine and Ursula remaining at home. Directors’ meetings are also occasionally held in Florida. Catherine discovers that she is being taxed on her directors’ fees in Mexico. Ursula is not. Assuming a specific exemption was not claimed under the GATS, has Mexico violated its MFN obligation?

In this case, again the answer is no. Article 15 of the U.S.-Mexico treaty permits Mexico to tax directors’ fees only if the services are performed outside the U.S. As the services are performed from within the U.S. no tax is exigible. In contrast, Article 16 of the Mexico-Canada Treaty allows the taxation of payments derived by a resident of a Contracting State in that resident’s capacity as a member of a Board of Directors of a corporation

\textsuperscript{123} See Treas. Tech. Explanation U.S.-Canada, \textit{supra} note 94, Art. 25(9); I.R.C. §274(h).

\textsuperscript{124} The restriction in IRC 274(h) has since been removed to allow for the deduction of convention expenses incurred in North America. However, the example remains useful in illustrating the potential effect of a tax treaty on the MFN obligation.
that is a resident of the other Contracting State. Thus Mexico is entitled to rely on the tax treaty to avoid its MFN obligation.

The three examples above provide factual and obvious illustrations of how tax discrimination is permitted in the NAFTA bloc under a tax treaty despite MFN obligations assumed under a trade agreement. Sometimes the answers to the questions "Has tax discrimination occurred?" and if so, "Does the tax treaty apply?" are not as obvious. Consider the following example.

4. Example Four

A new Goods and Services Tax (GST) surcharge of 2% is introduced by the Government of Canada that will apply to any income earned by a non-resident from the provision of services in Canada if their income from such services earned in Canada exceeded $50,000 in the prior year. Susan, a U.S. resident carrying on business and providing consulting services in Canada, is informed that she is obligated to collect and remit this additional tax. Has the national treatment obligation under the NAFTA been violated? The answer is—not likely.

Subject to a tax treaty, the national treatment obligation under the NAFTA,125 (and the GATS if applicable),126 prohibits governments from using taxes such as sales taxes, excise taxes and VAT taxes to discriminate against cross-border service providers or, in the case of the NAFTA, their investments. Ordinarily this would include a tax like the GST. However, the Canada-U.S. Treaty appears to selectively override in the case of a GST dispute involving the national treatment obligation. Specifically, the non-discrimination article in that tax treaty applies to all taxes imposed by a Contracting Party. The issue is, "Does the non-discrimination article in the tax treaty apply to the GST surcharge imposed on Susan, and if so, what is the result?"

The non-discrimination obligation under the Canada-U.S. Treaty clearly applies if Susan is an U.S. citizen who is resident in Canada.127 The tax treaty does not, however, impose a national treatment obligation with respect to U.S. citizen who is not resident in Canada or to a corporation that is resident in Canada, but controlled by U.S. citizens. Both of these groups are provided with a form of MFN128 but not national treatment under the tax treaty. Thus, one argument is that the tax treaty does not apply to Susan and therefore there is no restriction to prevent a dispute

125. NAFTA, supra note 2, Art. 1703.
126. The GATS, supra note 3, Art. XVII, assuming a commitment has been by the country in that sector in their Schedule of commitments.
127. Canada-U.S. Treaty, supra note 6, Art. 25(1).
128. Ibid., Arts. 25(2), 25(5).
about the discriminatory imposition of GST on an U.S. service provider who is not a resident of Canada from being brought under the NAFTA. An alternate argument is found both in the wording of Article 25(2) of the tax treaty, which addresses the treatment of non-resident citizens, and in the wording of Article 2103(2) of the NAFTA. The latter provides that nothing in the NAFTA "shall affect the rights and obligations of any Party under any tax convention. In the event of any inconsistency... the convention shall prevail."\(^{129}\) Since Susan’s rights as a non-resident Citizen and the Government of Canada’s obligations to her appear to be well-established under the tax treaty, this provision may end Susan’s legal complaint about tax discrimination under the NAFTA. The reasoning would be that since protection was not provided under the tax treaty for a non-resident citizen of the other Contracting State, such a right should not arise under a trade agreement. Put differently, inferring a right under a trade agreement in these circumstances would affect the rights and obligations of the parties under a tax treaty contrary to Article 2103(2) of the NAFTA.

The same argument that a tax treaty restricts a possible NAFTA claim cannot be made under the Mexico-Canada Treaty. The non-discrimination article in that treaty provides national treatment to nationals of the other State in the same circumstances. This would presumably apply to a Mexican national who is a tax resident of Canada. Unlike the Canada-U.S. Treaty, however, this treaty is silent about the required treatment of a Mexican Service provider who is a non-resident of Canada. Again the question arises – if the tax treaty is silent about whether national treatment is required, is a remedy under the NAFTA available, or must one conclude that there is no obligation to provide either MFN or national treatment to non-resident nationals of the other State in respect of direct tax matters who are not in the same circumstances?

Is there a remedy for Susan’s plight under the GATS? Again, the answer is likely not. At issue is the meaning of the words in the Third protocol to the Canada-U.S. Treaty, which state that for the purposes of the GATS, Canada and the U.S. agree that a measure will fall under the tax treaty if the measure relates to a tax to which Article 25 applies (non-discrimination). This dispute over the discriminatory imposition of the GST relates to Article 25.\(^{130}\) The obligation to provide national treatment and thus the protection against discrimination is simply not provided. The argument against a successful claim under the GATS is further reinforced by the wording of Article XXII(3), which provides that a Member may not invoke the national treatment article with respect to “a measure of

\(^{129}\) NAFTA, supra note 2, Art. 2103(2).

\(^{130}\) Canada-U.S. Treaty, supra note 6, Art. 25(10).
another Member that falls within the "scope" of an international agreement between them relating to the avoidance of double taxation."\textsuperscript{131} As the issue of national treatment is addressed in Article 25 of the tax treaty, the wording of Article XXII(3) may preclude a complaint. At issue will be how Article XXII(3) is interpreted, and in particular, what falls within the scope of a tax treaty.

In summary, notwithstanding that Article 2 of the Canada-U.S. Treaty restricts the application of the treaty provisions to taxes covered under the \textit{Income Tax Act} in the case of Canada, and the U.S. \textit{Internal Revenue Code of 1986} (and certain other identified taxes) the scope of the non-discrimination article in the tax treaty is crafted to be considerably more broad. If interpreted broadly, and in conjunction with Article XXII(3) of GATS, an argument can be made that all taxes affecting trade in services that are imposed by the U.S. or Canada must be resolved under the tax treaty as the issue of non-discrimination with respect to all taxes is addressed under the tax treaty.

In contrast, assume the complainant is a service provider from Mexico. Under the Mexico-Canada Treaty, income taxes, but not the GST, are subject to the treaty.\textsuperscript{132} Consequently, in similar circumstances, a dispute about the discriminatory imposition of the GST would be resolved under the national treatment provisions in the NAFTA (or the GATS) and not under the Mexico-Canada Treaty.

This example demonstrates that while one NAFTA partner may have no remedy or may be confined to the mutual agreement procedure mechanism in the tax treaty, another similarly situated NAFTA service provider may have recourse to the NAFTA dispute resolution mechanisms and may have recourse to the WTO dispute resolution procedures.\textsuperscript{133} A careful examination of each of the NAFTA tax treaties is required to determine precisely what obligations are assumed under the tax treaty and how these relate to the obligations assumed by the particular country under the NAFTA and the GATS. The answer to both questions is preliminary.

\textsuperscript{131} GATS, supra note 2, Art. XXII(3).

\textsuperscript{132} Mexico-Canada Treaty, supra note 6, Art. 2(3). The provision states that the treaty applies only to taxes imposed under the \textit{Income Tax Act} in the case of Canada. The GST is imposed under the \textit{Excise Tax Act}, R.S. 1985, c. E-13.

\textsuperscript{133} For example, the non-discrimination article in the U.S.-Mexico Treaty applies to all taxes including those imposed by political subdivisions and local authorities; see U.S.-Mexico Treaty, supra note 6, Art. 25. To the extent that the tax treaty prevails under an international trade agreement, the treaty dispute resolution provisions apply. In contrast, in the tax treaties between the U.S. and Canada and Canada and Mexico the non-discrimination provisions bind only the federal governments. Disputes about taxes imposed by political subdivisions or local authorities are therefore not part of the exclusive jurisdiction granted to tax agreements in resolving disputes.
to a determination of whether discrimination has occurred and, if so, what potential remedy is available. Consider the following two examples.

5. Example Five
The Province of Ontario (Canada) will not permit a deduction in calculating taxable income for Ontario tax purposes for amounts paid to non-residents (but not residents) of Canada that exceed $100,000 per annum. An Ontario client denies a U.S. engineer, earning income in excess of $100,000 in Ontario, further work. The U.S. government seeks to challenge the Ontario tax as a violation of the national treatment obligation under the NAFTA. Is this the appropriate dispute resolution forum or will the Canada-U.S. Treaty restrict any available remedy to the competent authority procedure under the tax treaty? The answer is yes: NAFTA is the appropriate forum despite the tax treaty.

The non-discrimination article in the Canada-U.S. Treaty applies only to tax levied by the Government of Canada. Provincial taxes are not covered by the tax treaty, except for the limited purpose of defining the scope of the obligation of the other Contracting State to provide relief from double taxation. Thus, there is no restriction, based on the argument that the matter is covered by a tax treaty, to prevent a dispute about a discriminatory provincial income tax from being brought under the NAFTA. Further, the NAFTA imposes a national treatment obligation as the tax relates to the purchase or consumption of cross-border services. There is a clear argument that the national treatment obligation has been violated.

Could the U.S. Government argue there has been a national treatment violation under the GATS, assuming a commitment by Canada in this sector? The answer appears to be no. Article 26(7) of the Canada-U.S. Treaty addresses the issue of the deductibility of expenses and provides that in determining the taxable profits of a resident, disbursements paid to a resident of the other contracting state shall be deductible under the same conditions as if they had been paid to a resident of the aforementioned State. Thus, the matter must be addressed under the tax treaty.

Assuming the engineer is from Mexico, could the Mexican Government argue there has been a national treatment violation under the GATS? The answer is maybe. Whether or not a claim can be made under the WTO dispute resolution procedures will depend on the specific commitments and

134. Canada-U.S. Treaty, supra note 6, Art. 24(7).
135. The same is true if the engineer were from Mexico. The Mexico-Canada Treaty applies only to taxes imposed by the Government of Canada under the Income Tax Act and not to income taxes imposed by the provinces. Thus the Mexican government can also challenge the tax as being in violation of Canada’s national treatment obligation under the NAFTA.
exemptions claimed by Canada in its schedule to the GATS.\textsuperscript{136} Assuming a commitment by Canada to provide national treatment, the issue will again be based on the interaction between Article XXII(3) of the GATS and the Canada-Mexico Treaty. The issue is whether the matter falls with the ‘scope’ of a tax treaty, given the non-discrimination article and interpretive rules in the Canada-Mexico Treaty.\textsuperscript{137}

The tax treaty specifically addresses the right of a national who is a resident, in the context of tax requirements “that are other or more burdensome”. It is arguable that all aspects of the national treatment obligation fall within the scope of the Canada-Mexico Treaty. The other view is that the national treatment obligation in respect of a national who is a non-resident does not fall within the scope of a tax treaty and thus, access to the WTO dispute resolution procedures is available.

6. \textit{Example Six}

In contrast to the above example if the deduction was not permitted by the State of California with respect to the services provided by an engineer from Mexico in California, the non-discrimination Article of the U.S.-Mexico treaty would clearly apply.\textsuperscript{138} and access to the NAFTA and the WTO dispute resolution mechanisms would be denied. This conclusion follows from the specific wording of the U.S.-Mexico Treaty, which states that it applies to all taxes imposed, including those imposed by political subdivisions. As a result, it would appear that any dispute about a California tax measure that impacts the deductibility of non-resident fees earned in California must be resolved through the competent authority procedure under the U.S.-Mexico Treaty.

\textit{Conclusion}

Trade agreements ensure national treatment, MFN trade status and a host of other negotiated trade benefits to service providers who provide services to a NAFTA partner. Similar guarantees do not extend to the tax treatment of these service providers. Instead the right of a host country to impose tax on foreign service providers is determined bilaterally under tax treaties. A number of consequences follow.

\textsuperscript{136} See discussion, \textit{supra} note 14.

\textsuperscript{137} OECD Model Treaty, \textit{supra} note 5. The OECD commentary to Article 25 of the tax treaty at para 44.5 includes the following discussion of the scope of a tax treaty: “the phrase ‘falls within the scope’ is inherently ambiguous, as indicated by the inclusion in paragraph 3 of Article XXII of the \textit{GATS} both an arbitration procedure and a clause exempting pre-existing conventions from its application in order to deal with disagreements related to its meaning. While it seems clear that a country could not argue in good faith that a measure relating to a tax to which no provision of a tax convention applied fell within the scope of that convention, it is unclear whether the phrase covers all measure that relate to taxes that are covered by all or only some provisions of the tax convention.”

\textsuperscript{138} See U.S.-Mexico Treaty, \textit{supra} note 6, Art. 25(4), 25(6).
First, as we have seen, the NAFTA tax treaties contain critical differences with respect to the taxation of treaty partners, particularly with respect to the tax treatment of service-related payments. These differences reverse the benefits of most favored nation treatment and affect the national treatment obligations that are critical to trade law discipline. The Canadian tax liability for an U.S. taxpayer, for example, who earns income from the provision of services in Canada, may also be very different than that of a Mexican taxpayer in identical circumstances.\textsuperscript{139}

Second, there are significant differences in the obligations assumed under the non-discrimination articles in the tax treaties. This will impact what rights a foreign service provider will have with respect to an assertion of tax discrimination and with respect to dispute resolution alternatives. As we have seen, both will vary widely among the NAFTA partners.

Third, tax measures, as currently disciplined under tax treaties, can be used by the NAFTA governments to both raise impediments to the cross-border trade in services and to provide trade-distorting subsidies far more egregious than practices prohibited in trade agreements.\textsuperscript{140} Such practices would clearly negate the benefits negotiated under trade agreements.

One might conclude that these consequences are an acceptable part of commerce in a free trade zone. If one does not accept this conclusion, are there obvious alternatives to the current regime?

A number of suggestions for alternatives have been made. For example, some have argued that income tax should be disciplined in trade agreements. The primary argument against such an inclusion concerns issues of state sovereignty.\textsuperscript{141} Conversely, it has been suggested that the role of tax treaties could be expanded to include trade-related matters. This alternative would, however, merely exacerbate differences in treatment among the NAFTA partners if the tax treaties remain bilateral. Still others have recommended that a single trilateral treaty should operate in the NAFTA bloc to ensure similar treatment for each of the NAFTA partners when earning income in a NAFTA country. This solution would not, however, resolve the problem

\textsuperscript{139} See Example 1 above for discussion.
\textsuperscript{140} Although it would appear that little discipline with respect to MFN and national treatment obligations is imposed in income tax matters, this is not entirely true. The Appellate Body of the WTO has stated that "[a] Member of the WTO may choose any kind of tax system that it wishes—so long as, in so choosing, that Member applies that system in a way that is consistent with its WTO obligations." This quote came in the context of the dispute about the U.S. FSC program. At issue was whether the U.S. was providing export subsidies through its foreign sales corporation provisions. See WTO, \textit{U.S.-Tax Treatment for "Foreign Sales Corporations"}, WTO Doc. WT/DS108/AB/R, Report of the WTO Appellate Body (24 February 2000).
of adjudication of tax treaty issues by interested competent authorities, that may be unwilling to apply the well developed principles with respect to discrimination that are required in a trade law context. Therefore, others argue a more dramatic solution is needed, such as a world tax court to interpret and apply tax treaties. However, the establishment of such a court would not ensure parity of treatment among service providers as long as tax treaties remain bilateral.

Each of these suggestions address only identified symptoms of tax discrimination arising out of the current regime. Therefore, this article concludes that they are insufficient and that more research is needed to fully understand the potential implications of excluding tax discipline from trade agreements and the impact this may have on tax discrimination in the NAFTA bloc in the future. In particular, more research is needed to determine whether the obligations assumed under trade agreements will have application to tax matters in other ways not anticipated when each of the NAFTA countries first entered into them. Such research could usefully draw on recent experience in the European Community (EC) and in particular, tax discrimination practices identified there.

Information gathered from the EC could also provide useful signposts for monitoring such research could usefully draw on recent experience in the European Community (EC) and in particular, tax discrimination practices identified there.

142. John Arnt, "Tackling Tax Treaty Tensions: Time to Think About an International Court" (1998) 52 Bulletin for International Fiscal Documentation 344. Arnold et al., ibid. at 72. 143. The existing academic literature is beginning to consider this question as well as other potential issues that might arise from interaction of tax and non-tax treaties Jeffrey M. Lang, Robert B. Stack, Steve Charnovitz & Joshua T. Brandy, "What Tax Lawyers Should Know About Trade Law" (2000) 29 10 Tax Management International Journal 566. H. David Rosenbloom, "What's Trade Got to Do With It?" (1994) 49:4 Tax Law Review 593; Arnold et al., supra note 142. Some of the issues explored in existing literature include whether trade agreements should address tax issues, see Alvin C. Warren, "Income Tax Discrimination Against International Commerce" (2001) 54:2 Tax Law Review 131, or whether the role of tax treaties should be expanded to include trade related matters. Other authors query whether there are coherent principles underlying prohibited and permitted income tax discrimination when tax and trade agreements are considered together, see Ramon J. Jeffery, The Impact of State Sovereignty on Global Trade and International Taxation (Boston: Kluwer Law International, 1999), or whether the very principles underlying tax treaties are compatible with the principles underlying existing and future multilateral trade and investment agreements.

144. Recent developments in the European Community (EC) make it clear that tax obstacles may be erected by member countries that will affect cross-border service providers in ways not addressed in either pertinent tax treaties or the WTO Agreement. The European Court of Justice has resolved many of these matters by an interpretation of the fundamental freedoms (including the freedom of movement) guaranteed to EC members. Guidance will be sought from the growing body of case law on discrimination in tax matters, and from case law on the use of tax measures as an international obstacle to trade in services. Important lessons can be learned from the EC experience about how tax discrimination can occur, which can be further applied in the NAFTA context despite differing principles of economic integration. The project will further examine possible solutions, which may be devised in Canada without the benefit of an equivalent to the Treaty on European Union, with protocols, 7 February 1992, 9 D.J.I. 553 (entered into force 1 November 1993) (the "Maastricht Treaty").
activity among the NAFTA partners and in formulating recommendations about how tax should be disciplined in future trade agreements.

Meanwhile, service providers in the NAFTA bloc will remain subject to differing tax treatment, are potentially vulnerable to different types of tax discrimination and will have resort to different dispute resolution alternatives. These differences will no doubt be of concern to both cross-border service providers and their advisors. The role of tax in trade agreements will also no doubt be of concern to the NAFTA governments. Hopefully this concern will ensure that the matter of tax discrimination will remain a compelling issue in each countries trade agenda, and in the ongoing negotiations under the Free Trade of the Americas Agreement.¹⁴⁵
