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Trade in Technology within the Free Trade Zone: The Impact of the WTO Agreement, NAFTA, and Tax Treaties on the NAFTA Signatories

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I. INTRODUCTION

Trade in technology and related services has assumed a major role both on the world trade agenda and within the NAFTA block. The success of such cross-border trade is dependent upon three factors: protection of intellectual property,[1] access to foreign markets by service providers, and a minimized risk of double taxation. Each of these factors is impacted by national laws, multinational conventions, and bilateral tax treaties. The last decade has witnessed an explosion of such legislation and agreements. This article focuses on Canada, Mexico and the United States, and explores the

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[1] "Intellectual property" is the product of human creativity. "Intellectual property rights" are the rights granted to persons over the creations of their minds. The term is used to describe such intellectual property as patents, trademarks, copyrights, trade secrets, plant patents, design patents, integrated circuits, and computer software and databases.

World Trade Organization Agreement ("WTO Agreement"),[2] the North American Free Trade Agreement ("NAFTA"),[3] and the bilateral tax treaties entered into by Canada, Mexico, and the United States, the three NAFTA signatories, and analyzes both their impact and interaction on cross-border trade in technology and related services. The purpose of this article is to provide a framework for understanding the international environment in which trade in technology occurs within the NAFTA block. Its goal is to provide sufficient information to allow advisors to effectively plan for and structure such cross-border arrangements. Part II begins with a discussion of the multinational agreements entered into by Canada, Mexico, and the United States that effect cross-border trade in intellectual property and related services, and then focuses on the WTO Agreement and NAFTA. Part III examines the manner in which the WTO Agreement and NAFTA interact with the bilateral tax treaties entered into by the three NAFTA signatories. Part IV analyzes the effect of tax treaties on income generated in the cross-border trade in technology and related services, and highlights the significant differences in treatment among the NAFTA partners. Finally, Part V offers some recommendations and conclusions.

II. INTERNATIONAL AND REGIONAL CONVENTIONS

A. Trade in Intellectual Property: Legal Protection

As the goods traded in the world market have increasingly included technology-intensive products, the licensing of information, and the trade in services, intellectual property protection has become one of the most visible issues in world trade negotiations. The inadequate protection of intellectual property and related services is viewed as a nontariff barrier to trade, particularly by technologically advanced countries who have more to lose if uncompensated for their research and development efforts. This is not to suggest that the protection of intellectual property in the global marketplace has not been a priority for some decades. Specifically, Canada, Mexico, and the United States have long been signatories to a variety of multilateral intellectual property protection agreements. However, in the last decade, intellectual property protection has become a key component of the two most significant trade agreements entered into by Canada, Mexico, and the United States, those being the WTO Agreement, succeeding the General Agreement on Tariffs and Trade ("GATT 1947"),[4] and NAFTA.[5] The fol-

[2] Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Apr. 15, 1994, LEGAL INSTRUMENTS–RESULTS OF THE URUGUAY ROUND vol. 1 (1994), 33 I.L.M. 1141 (1994) [hereinafter WTO Agreement].

[3] North American Free Trade Agreement, Dec. 17, 1992, 32 I.L.M. 289 (1992) [hereinafter NAFTA] (entered into force January 1, 1994).

[4] General Agreement on Tariffs and Trade, *opened for signature* Oct. 30, 1947, 61 Stat. A3, 55 U.N.T.S. 187 [hereinafter GATT 1947]. GATT 1994, an amended and updated ver-

lowing discussion outlines these international intellectual property agreements and the intellectual property obligations assumed under the WTO Agreement and NAFTA.

1. Multilateral Intellectual Property Agreements

At the core of intellectual property protection is national sovereignty. Intellectual property rights are granted in the case of patents and industrial designs and recognized for trademarks and copyrights by the individual countries; however, the rights so granted and recognized are coextensive with the territorial limits of each country. To protect or exercise those rights in any other country, cooperation with that other country is a prerequisite.[6]

In addition to boasting well-developed domestic legislation, Canada and the United States have long been signatories to the many multilateral international intellectual property agreements. Since 1991, Mexico has substantially revised its intellectual property protection[7] as evidence of its

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sion of the original GATT Agreement of 1947, is an integral part of the WTO Agreement. *See* WTO Agreement, *supra* note 2 (incorporating the provisions of GATT 1947); *see also* Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Apr. 15, 1994, LEGAL INSTRUMENTS–RESULTS OF THE URUGUAY ROUND vol. 1 (1994), 33 I.L.M. 1125 (1994) [hereinafter GATT 1994] (embodying the final discussions of the Uruguay Round).

[5] NAFTA, *supra* note 3. Canada, Mexico, and the United States have also entered into other regional trade agreements within North and South America. Examples include the Canada-U.S. Free Trade Agreement between the United States and Canada, which came into effect on January 1, 1989. Free Trade Agreement, Dec. 22, 1987, and Jan. 2, 1988, Can.-U.S., H.R. Doc. No. 216, 100th Cong., 2d Sess. at 297 (1988), *reprinted in* 27 I.L.M. 281 (1988) [hereinafter FTA]. The FTA was officially suspended in January 1994; nevertheless, if NAFTA failed or either Canada or the United States withdrew from NAFTA, the FTA will again enter into force and continue to bind the two countries. DEPARTMENT OF STATE, 1998 COUNTRY REPORTS ON ECONOMIC POLICY AND TRADE PRACTICES: CANADA 232 (1998). Mexico signed the Montevido Treaty of 1980 to create the Associacion Latinoamericana de Integracion-ALADI (LAIA) which includes Argentina, Bolivia, Brazil, Chile, Columbia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela. In 1995, Mexico also entered into a free trade agreement, the Group of Three (G-3), with Colombia and Venezuela. *See* INT'L BUREAU OF FISCAL DOCUMENTATION, INT'L & REG'L AGREEMENTS, LATIN AMERICAN TAXATION § 2.1(a) (1998).

[6] Eric Hubar Meunier, *Introduction: Intellectual Property*, to CROSSBORDER TRANSACTIONS, at XI, Meredith Lectures, 1993, Faculty of Law, McGill University, (on file with author).

[7] *See* "Law for the Promotion and Protection of Industrial Property," D.O., June 27, 1991, as amended by D.O. of August 2, 1994 [IPA]; Regulation for the Promotion and Protection of Industrial Property, D.O. of November 23, 1994. One of the most significant changes was the creation of the Mexican Institute of Industrial Property (IMPI). The IMPI, a decentralized organization, has administrative authority over industrial property to coordinate intellectual property protection, including jurisdiction to resolve disputes. Prior to 1991, Mexico's Technology Transfer Commission had total control over the terms and conditions of technology transfer agreements.

commitment both to the protection of intellectual property rights and to the consummation of NAFTA with the United States and Canada. Mexico is also a signatory to many of the international intellectual property agreements.

The World Intellectual Property Organization ("WIPO"),[8] a specialized agency of the United Nations headquartered in Geneva, was created in 1967 to administer multilateral agreements. Canada, Mexico and the United States are signatories to the following multilateral intellectual property agreements administered by WIPO.[9] Among the most important of these agreements is the Convention for the Protection of Industrial Property ("Paris Convention").[10] The Paris Convention protects industrial property in the form of patents, utility models, industrial designs, trademarks, trade names, marks of origin and inventor's certificates.[11] Patent rights are further enhanced under the Patent Cooperation Treaty ("PCT") which allows an applicant to file an international application for patent protection simultaneously in seventy-four Member States.[12] Furthermore, international copyrights are protected through the Berne Convention for the Protection of Literary and Artistic Works ("Berne Convention"),[13] the International Convention for the Protection of Performers, Producers of Phonograms and

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[8] Convention Establishing the World Intellectual Property Organization, July 14, 1967, 21 U.S.T. 1770, 828 U.N.T.S. 3 [hereinafter WIPO].

[9] Mexico is not a signatory to the Treaty on Intellectual Property in Respect of Integrated Circuits. Treaty on Intellectual Property in Respect of Integrated Circuits, *opened for signature* May 26, 1989, 28 I.L.M. 1477 (1989) [hereinafter IPIC Treaty]. The United States is not a signatory to the International Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organizations. International Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organizations, Oct. 26, 1961, 496 U.N.T.S. 43 [hereinafter Rome Convention].

[10] Convention for the Protection of Industrial Property, Mar. 20, 1883, 21 U.S.T. 1630, 828 U.N.T.S. 305, *as revised* at Stockholm, July 14, 1967 [hereinafter Paris Convention]. The United States became a signatory in 1967. *Id.* The agreement came into force with the United States on September 5, 1970. *Id.* Canada became a signatory to the agreement on July 7, 1970. *Id.* Mexico became a signatory to the agreement on July 26, 1976. *Id.*

[11] *Id.* Important provisions of the Paris Convention include the granting of "national treatment" to its Member States and the right of priority to foreigners dating from the initial filing date, provided the foreigner files within one year of filing in their own country. *Id.*

[12] Patent Cooperation Treaty, June 19, 1970, 28 U.S.T. 7645 [hereinafter PCT]. Canada became a signatory on January 2, 1990. *Id.* The agreement entered into force in the United States on January 24, 1978. *Id.* Mexico became a signatory on January 1, 1995. *Id.* The agreement effectively extends the priority period for filing from the 12-month limit set by the Paris Convention to an 18-month limit, but it does not eliminate the separate prosecutions and examinations within each Member State. *Id.*

[13] Berne Convention for the Protection of Literary and Artistic Works, Sept. 9, 1886 (amended Oct. 2, 1979), 828 U.N.T.S. 221 [hereinafter Berne Convention]. Canada became a signatory on April 10, 1928. *Id.* Mexico became a signatory on June 11, 1967. The agreement did not become effective in the United States until March 1, 1989.

Broadcasting Organizations ("Rome Convention")[14] and the Universal Copyright Convention ("UCC Convention").[15] The NAFTA partners are also signatories to multilateral agreements which protect other types of intellectual property. For example, international protection is offered for phonograms through the Convention for the Protection of Producers of Phonograms Against Unauthorized Duplication of their Phonograms ("Geneva Convention"),[16] plants through the International Convention for the Protection of New Varieties of Plants ("UPOV Convention"),[17] and semiconductor chips through the Treaty on Intellectual Property in Respect of Integrated Circuits ("IPIC Treaty").[18]

These intellectual property agreements, however, were considered insufficient by many developed countries, particularly the United States,[19] to adequately protect trade in technology which is so clearly becoming a focal point in world trade. Specifically, the agreements did not create transna-

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[14] Rome Convention, *supra* note 9. Mexico became a signatory on May 18, 1964. *Id.* Canada became a signatory on June 4, 1998. *Id.*

[15] Universal Copyright Convention, *opened for signature* Sept. 6, 1952, 6 U.S.T. 2732, 216 U.N.T.S. 132, *revised* July 24, 1971, 25 U.S.T. 1341, 943 U.N.T.S. 194 [hereinafter UCC Convention]. The United States became a signatory on July 10, 1974. *Id.* Canada became a signatory on August 10, 1962. *Id.* Mexico became a signatory on May 12, 1957. *Id.* The United States withdrew from the UCC Convention in 1988. 17 U.S.C. § 101 (1988).

[16] Convention for the Protection of Producers of Phonograms Against Unauthorized Duplication of their Phonograms, Oct. 29, 1971, 25 U.S.T. 309, 866 U.N.T.S. 67 [hereinafter Geneva Convention]. Canada became a signatory on October 29, 1971. *Id.* The U.S. agreement entered into force March 10, 1974. *Id.* Mexico became a signatory on December 21, 1973. *Id.*

[17] International Convention for the Protection of New Varieties of Plants, Dec. 2, 1961, 33 U.S.T. 2703, 815 U.N.T.S. 89 [hereinafter UPOV]. This Convention protects new plant varieties and was intended to ensure plant breeders a fair return on their investment. *Id.* Canada became a signatory on February 4, 1991. *Id.* The agreement entered into force in the United States on November 8, 1981. *Id.* Mexico became a signatory on August 9, 1997. *Id.*

[18] IPIC Treaty, *supra* note 9. The United States adopted the IPIC Treaty May 26, 1989. *Id.* Canada ratified the agreement on February 4, 1991. *Id.*

[19] As a result of very large technology transfer losses, the United States created its own régime of international protection by establishing "Special 301" procedures in the 1988 Omnibus Trade and Competitiveness Act designed to unilaterally protect U.S. intellectual property rights. These procedures are generally used to obtain market access for U.S. exporters of goods and services, but can also be used to pressure and perhaps sanction other nations whose intellectual property policies fall below U.S. standards and with whom negotiations to cure such practices fail. Special 301 requires the U.S. Trade Representative to identify and develop "watch lists" and "priority watch lists" of foreign countries that deny adequate and effective protection of intellectual property rights or deny fair and equitable market access for U.S. persons. 19 U.S.C. § 1337 (1988); Trade Act of 1974, Pub. L. No. 93-618, 182, 88 Stat. 1978, 2041 (1975) (codified as amended at 19 U.S.C. § 2242 (1994)) [hereinafter Special 301]. Much of the perceived necessity for these provisions was eliminated by TRIPS. *See* Robert J. Pechman, *Seeking Multilateral Protection for Intellectual Property: The United States "TRIPS" Over Special 301*, 7 MINN. J. GLOBAL TRADE 179 (1998).

tional rights or harmonize administrative practices; rather, they merely coordinated national protection and other minimal national rights. WIPO, the obvious choice for a new intellectual property agreement, was viewed by many as lacking the critical abilities to consult, enforce or require dispute resolution in a trade context.[20] It also held no power over non-Member States or their citizens, who were most often those guilty of expropriating technology and of producing and selling pirated products in their own country and in the countries of Members. Thus, it was to GATT 1947 with its potentially broad-reaching hammer of trade sanctions and enforcement that the developed countries, in 1986, took their intellectual property agenda during the Uruguay Round of Negotiations. In 1994, the result was the WTO Agreement which included a new approach to the protection of intellectual property in the form of the Trade Related Aspects of Intellectual Property Agreement ("TRIPS").[21] As part of the WTO Agreement,[22] in 1995, the World Trade Organization ("WTO") was created[23] to facilitate the implementation of the results of the Uruguay Round and administer trade dispute settlement procedures established pursuant to the WTO Agreement.

2. *TRIPS*

TRIPS, built upon WIPO's pioneer efforts, "include[s] norms, standards and principles on the availability, scope and use of intellectual property rights; mechanisms for internal and border enforcement; and dispute settlement procedures" that would reduce obstructions to legitimate trade.[24] Although met with considerable resistance by many developing countries, the negotiations were brought to a successful close on April 15, 1994. The final agreement requires certain minimum standards of protection to be provided by each Member State for copyrights and related rights,[25] trade-

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[20] *See* JEFFREY S. THOMAS & MICHAEL A. MEYER, THE NEW RULES OF GLOBAL TRADE 252 (1997) (discussing the new rules of global trade).

[21] Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, LEGAL INSTRUMENTS–RESULTS OF THE URUGUAY ROUND vol. 31; 33 I.L.M. 81 (1994) [hereinafter TRIPS].

[22] WTO Agreement, *supra* note 2.

[23] Marrakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994, LEGAL INSTRUMENTS–RESULTS OF THE URUGUAY ROUND vol. 1; 33 I.L.M. 1144 (1994) [hereinafter WTO]. *See generally* Frank Romano, *International Conventions and Treaties*, 536 PLI/PAT 545 (1998) (providing a discussion on the significant international conventions and treaties).

[24] U.S. TRADE OBJECTIVES IN THE URUGUAY ROUND, U.S. DEPARTMENT OF STATE BULLETIN, VOL. 89, PUB. NO. 2143, 36 (1989), *cited in* Eric Wolfhard, *International Trade in Intellectual Property: The Emerging GATT Régime,* 49 U. TORONTO FAC. L. REV. 106, 109 (1991); *see also* TRIPS, *supra* note 21, Art. 7 (setting forth the objectives of TRIPS with respect to the protection and enforcement of intellectual property rights).

[25] TRIPS, *supra* note 21, Arts. 9-14. In general, TRIPS requires compliance with the basic standards of the Berne Convention. *Id.* Art. 9. Computer programs are protected as liter-

marks,[26] geographical indications,[27] industrial designs,[28] patents,[29] layout-designs of integrated circuits,[30] and trade secrets and know-how.[31] Under

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ary works under the Berne Convention. *See* Berne Convention, *supra* note 13. In addition, databases and other compilations of data or other material are protected under copyright even where the databases include data that are not protected under copyright law. *See* TRIPS, *supra* note 21, Art. 10 (providing that the protection of compilations of data or other material "shall be without prejudice to any copyright subsisting in the data or material itself"). According to the general rule contained in Article 7(1) of the Berne Convention, the term of protection is the life of the author plus 50 years after the death of the author. Berne Convention, *supra* note 13, Art. 7(1).

[26] TRIPS, *supra* note 21, Arts. 15-21. "Any sign, or any combination of signs, capable of distinguishing the goods or services of one undertaking from those of [another] shall be capable of constituting a trademark. Such signs, in particular words including personal names, letters, numerals, figurative elements and combinations of colors [are] eligible for registration as a trademark." *Id.* Art. 15(1). "The owner of a registered trademark [has] the exclusive right to prevent all third parties . . . from using . . . identical or similar signs for goods or services which are identical or similar to those in respect of which the trademark is registered where such use would result in a likelihood of confusion." *Id.* Art. 16(1). The term of protection is no less than seven years. *Id.* Art. 18.

[27] *Id.* Arts. 22-24. "Geographical indications are . . . indications which identify a good as originating in the territory of a Member . . . where a given quality, reputation or other characteristic of the good is essentially attributable to its geographical origin." *Id.* Art. 22(1). Interested parties have the legal right to prevent the use of indications which mislead the public "as to the geographical origin of the good; [and] any use which constitutes an act of unfair competition within the meaning of Article 10 *bis* of the Paris Convention." *Id.* Art. 22(2); Paris Convention, *supra* note 10, Art. 10 *bis*.

[28] *Id.* Arts. 25-26. "Members shall provide for the protection of independently created industrial designs that are new or original." *Id.* Art. 25(1). The duration of protection is at least 10 years. *Id.* Art. 26(3).

[29] *Id.* Arts. 27-34. The patent provisions require Members to make patents "available for any inventions, whether products or processes, in all fields of technology, provided that they are new, involve an inventive step and are capable of industrial application . . . without discrimination as to the place of invention . . . and whether the products are imported or locally produced." *Id.* Art. 27(1). Nevertheless, a Member may exclude from patentability certain inventions, if necessary, for the protection of public order or morality, including protecting "human, animal or plant life or health or to avoid serious prejudice to the environment." *Id.* Art. 27(2). "Members may also exclude from patentability: (a) diagnostic, therapeutic and surgical methods for the treatment of humans or animals; (b) plants and animals other than micro-organisms, and essentially biological processes for the production of plants or animals other than non-biological and microbiological processes." *Id.* Art. 27(3). A product patent confers on an owner the exclusive right to make, use, offer for sale, sell or import. Process patent protection covers not only the use of the process but also the products obtained directly by the process. Patent owners also have the right to assign or license the patent. *Id.* Art. 28. The term of protection endures for a period of 20 years from the date of filing. *Id.* Art. 33.

[30] *Id.* Arts. 35-38. Layout-designs for integrated circuits are to be protected in accordance with the provisions of the IPIC Treaty which provides the definitions of "layout-design" and "integrated circuit," and also provides the requirements for protection, exclusive rights, and limitations, as well as exploitation, registration and disclosure. *Id.* Art. 35; *see also* IPIC Treaty, *supra* note 9, Arts. 2-7, 12, 16(3).

TRIPS, the minimum standard is established by requiring that the substantive obligations of the Paris Convention (industrial property),[32] the Berne Convention (literary and artistic work),[33] the Rome Convention (performers, producers of phonograms, and broadcasting organizations),[34] and the IPIC Treaty (integrated circuits)[35] be complied with, and by adding many substantive definitions, obligations, limitations, procedures, and remedies where the pre-existing agreements are inadequate or silent.

TRIPS recognizes the principals of "national treatment," "most-favored-nation treatment," and "transparency" in the protection of intellectual property rights. "National treatment" affords to the other Members treatment no less favorable than a Member accords to its own nationals with regard to the protection of intellectual property.[36] "Most-favored-nation treatment" requires that any advantage, favor, privilege or immunity granted by a Member to the nationals of any other country is accorded immediately and unconditionally to the nationals of other Members.[37] Finally, with regard to dispute prevention and settlement, TRIPS requires "transparency" such that the "[l]aws and regulations, and final judicial decisions and administrative rulings of general application, made effective by any Member pertaining to the subject matter of [TRIPS] . . . shall be published . . ." or otherwise made available.[38]

Further, TRIPS provides a detailed system with procedural norms and remedies that must be available under national laws to effectively enforce intellectual property rights.[39] TRIPS contains provisions regarding the enforcement of intellectual property rights, such as civil and administrative procedures, provisional and final remedies, criminal penalties, and border enforcement.[40] The objectives of these provisions are to ensure that enforcement procedures are available under the laws of the Member countries "so as to permit effective action against any act of infringement of intellec-

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[31] TRIPS, *supra* note 21, Art. 39. The protection applies to information that is secret, that has commercial value because it is secret, and that has been subject to reasonable steps to keep it secret. *Id.* Art. 39(2).

[32] *See* Paris Convention, *supra* note 10, Art. 2(1).

[33] *See* Berne Convention, *supra* note 13, Art. 9(1).

[34] *See* Rome Convention, *supra* note 9, Art. 14(6).

[35] *See* IPIC, *supra* note 9, Art. 35.

[36] TRIPS, *supra* note 21, Art. 3(1). Exceptions to national treatment include the exceptions already provided in the Paris Convention, the Berne Convention, the Rome Convention or the IPIC Treaty. *Id.*

[37] *Id.* Art. 4. Exceptions to most-favored-nation treatment include exceptions provided in the Berne Convention and the Rome Convention. *Id.*

[38] *Id.* Art. 63(1).

[39] *See id.* Art. 41.

[40] *See id.* at Part III.

tual property rights covered by [TRIPS]," and that these procedures are applied in a manner that avoids the creation of barriers to trade.[41]

It is largely agreed that dispute settlement procedures are more effective under TRIPS than the former régime of multilateral intellectual property protection agreements. The Council for Trade-Related Aspects of Intellectual Property Rights was established to monitor Member compliance and administrative matters arising out of the agreement.[42] The Council also assists Members in dispute resolution procedures.[43] The Council, acting in its capacity as the Dispute Settlement Body, has the responsibility of settling disputes arising under TRIPS.[44] It was anticipated that this dispute settlement system might conflict with the national laws of some Members and, in particular, with U.S. "Special 301" trade sanctions.[45] Therefore, under its terms, the signatories to TRIPS must commit to follow the multilateral procedures established under the agreement, including dispute settlement, and not resort to national solutions.[46]

Under TRIPs, developed countries, including Canada and the United States, were granted one year to implement compliant intellectual property provisions domestically.[47] Developing countries and nations shifting from a centrally-planned economy to a market economy, such as Mexico, were given a five-year transition period.[48] The least developed nations were given an additional five years to set up compliant legislation.[49]

3. *NAFTA*

While the TRIPS provisions were being debated, NAFTA was also under negotiation. The obligations assumed under NAFTA regarding intellectual property are closely related to TRIPS; nevertheless, they provide more extensive protection to the NAFTA trade block partners.[50] The primary objective of Chapter 17 of NAFTA, as with TRIPS, is the protection and enforcement of intellectual property rights, and the prevention of the

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[41] *Id.* Art. 41(1).

[42] *Id.* Art. 68.

[43] *Id.*

[44] *Id.* Art. 64.

[45] *See* Special 301, *supra* note 19 (discussing the creation of "Special 301" procedures by the U.S. which are designed to unilaterally protect U.S. intellectual property rights).

[46] *See* TRIPS, *supra* note 21, Art. 1.

[47] *Id.* Art. 65.

[48] *Id.* Art. 65(2)-(3). An additional extension of five years is granted to developing nations providing patent protection to areas not previously covered by their patent provisions, such as pharmaceuticals and agricultural chemicals. *Id.* Art. 65(4).

[49] *Id.* Art. 66(1).

[50] *See generally* Kent S. Foster & Dean C. Alexander, *Opportunities for Mexico, Canada and the United States: A Summary of Intellectual Property Rights Under the North American Free Trade Agreement*, 20 RUTGERS COMPUTER & TECH. L.J. 67 (1994) (summarizing the protection of intellectual property rights under NAFTA).

use of such measures as barriers to legitimate trade.[51] If inconsistencies exist, unless otherwise specified in NAFTA, the provisions of NAFTA will prevail over the provisions of other trade agreements.[52]

"[T]o provide adequate and effective protection and enforcement of intellectual property rights,"[53] the minimum standards[54] to which each NAFTA signatory must adhere are the obligations required by NAFTA and, with certain modifications, the obligations required in the following multilateral intellectual property agreements: the Geneva Convention (Phonograms),[55] the Berne Convention (literary and artistic works),[56] the Paris Convention (industrial property),[57] and the UPOV Convention (new plant varieties).[58] Chapter 17 of NAFTA protects, or provides further protection to, copyrights,[59] sound recordings,[60] encrypted program-carrying satellite

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[51] NAFTA, *supra* note 3, Art. 1701(1).

[52] *Id.* Art. 103(2). The WTO approved NAFTA even though it violates the WTO's most-favored-nation treatment clause by providing exclusive benefits to its signatories. *See* GATT 1994, *supra* note 4, Art. XXIV (1994) (detailing the territorial application of GATT). Certain regional agreements were considered to be acceptable by the WTO based on the rationale that these agreements could lead to increased freedom of trade through closer integration of economics. *See* Frank Schoneveld, *The EEC and Free Trade Agreements-Stretching the Limits of GATT Exceptions To Non-Discriminatory Trade?*, J. WORLD TRADE, Oct. 1992, at 59 (analyzing whether the Free Trade Agreements are expanding the limits of the GATT exceptions to non-discriminatory trade).

[53] NAFTA, *supra* note 3, Art. 102(1)(d).

[54] *Id.* Art. 1701(2). However, a Party may implement domestic law with more extensive protection of intellectual property, provided such protection is not inconsistent with NAFTA. *Id.* Art. 1702.

[55] Geneva Convention, *supra* note 16.

[56] Berne Convention, *supra* note 13.

[57] Paris Convention, *supra* note 10.

[58] UPOV, *supra* note 17.

[59] *See* NAFTA, *supra* note 3, Art. 1705 (providing for the protection of copyrights). Generally, NAFTA protects all works covered by the Berne Convention and any other works embodying original expression within the Convention's meaning. *Id.* Art. 1705(1). Particularly, computer programs and compilations of data or other materials that by reason of the selection or arrangement are original, such as databases, are protected. *Id.* Art. 1705(1)(a)-(b). Authors and their successors in interest have the rights enumerated in the Berne Convention, including the right to authorize or prohibit reproductions, distributions, performances or displays of their work to the public. *Id.* Art. 1705(2). Authors of computer programs are also granted the right to prohibit the commercial rental of the software. This right will not apply "where the copy of the computer program is not itself an essential object of the rental." *Id.* Art. 1705(2). NAFTA also requires each government to permit the transfer of rights in literary or artistic works by contract and to allow the transferee to exercise and enjoy the full benefit of those rights. *Id.* Art. 1705(3). In addition, when the term of protection is not based on the life of a natural person, the minimum term of protection is 50 years. *Id.* Art. 1705(4).

[60] *Id.* Art. 1706. The producer of a sound recording has the right to control the importation, reproduction, and first distribution of the work. *Id.* Furthermore, the producer's consent to the introduction of a sound recording on the market does not exhaust the rental right.

signals,[61] trademarks,[62] patents,[63] layout designs of semiconductor integrated circuits,[64] trade secrets,[65] geographical indications,[66] and industrial

Id. Art. 1706(1). Also, the term of protection is "at least 50 years from the end of the calendar year in which the fixation was made." *Id.* Art. 1706(2).

[61] *Id.* Art. 1707. It is "a criminal offense to manufacture, import, sell, lease or otherwise make available a device or system" the primary purpose of which is to decode "an encrypted program-carrying satellite signal without the authorization . . . and a civil offense to receive . . . or further distribute [such] signal that has been decoded without the authorization." *Id.* Art. 1707(a)-(b).

[62] *Id.* Art. 1708. Similar to TRIPS, NAFTA provides a very broad definition of a trademark. "[A] trademark consists of any sign, or any combination of signs, capable of distinguishing the goods or services of one person from those of another." *Id.* Art. 1708(1). Examples include "personal names, designs, letters, numerals, colors, figurative elements, or the shape of goods or of their packaging." *Id.* The owner of a trademark has the right to prevent all persons from using identical or similar signs for goods and services where such use would result in a likelihood of confusion. *Id.* Art. 1708(2). Also, NAFTA requires a system for registration to be established, which includes an examination of the applications, notice with reasons for refusal to register, reasonable opportunity to respond to such notice, publication of each trademark, and reasonable opportunity for interested persons to cancel the registration of a trademark, and which may include "a reasonable opportunity for interested [parties] to oppose the registration of a trademark." *Id.* Art. 1708(4). In addition, "[i]mmoral, deceptive or scandalous matter, or matter that may disparage or falsely suggest a connection with persons, living or dead, institutions, beliefs or any Party's national symbols" can be denied registration. *Id.* Art. 1708(14). Registrability may be dependent on use. *Id.* Art. 1708(3). Use of a trademark is required to maintain a registration. *Id.* Art. 1708(8). The initial registration of a trademark is for a term of at least 10 years and the registration is indefinitely renewable for terms of no less than 10 years. *Id.* Art. 1708(7).

[63] *Id.* Art. 1709. NAFTA makes "patents available for any inventions, whether products or processes, in all fields of technology, provided [the] inventions are new, result from an inventive step and are capable of industrial application." *Id.* Art. 1709(1). A Party may exclude from patentability inventions, if necessary, to protect the public or morality. *Id.* Art. 1709(2). Additionally, certain limited subject matter may also be excluded from patentability, including: "diagnostic, therapeutic and surgical methods for the treatment of humans or animals; plants and animals other than microorganisms; and biological processes for the production of plants or animals." *Id.* Art.1709(3). However, patents for plant varieties, pharmaceuticals, microorganisms and microbiological processes and agricultural chemicals are specifically included in NAFTA. *Id.* Arts. 1709(3)-(4). The patent owner will have the right to prevent other persons from making, using, or selling the product or process without the owner's consent. *Id.* Art. 1709(5)(a)-(b). NAFTA also establishes tight restrictions on the use of compulsory patent licenses. *Id.* Art. 1709(10). The minimum term of protection for patents is 20 years from the date of filing or 17 years from the date of grant. *Id.* Art. 1709(12). Unfortunately, NAFTA does not address the issue of parallel imports or "grey marketing," a practice involving goods locally produced under rights in one jurisdiction and imported into the market of another country where the product rights are held by someone else. The result is a conflict between two products that were both legally produced in the home jurisdiction, but which infringe one set of home rights when sold abroad. The level of patent protection provided by NAFTA is a considerable improvement over the protection offered in other international agreements, including TRIPS. Despite the level of protection offered by NAFTA, it has been suggested that a North American Patent Treaty would better serve the needs of the Contracting Parties. *See* Jeffrey L. Thompson, *The North American Patent Office: A Comparative Look at the NAFTA, the European Community, and the Com-*

designs.[67] The most significant of these additional obligations include the codification of trade secret protection, an improved level of patent and copyright protection, and extended protection of integrated circuits.[68] Accordingly, NAFTA provides important new protections for industries involved in telecommunications, pharmaceuticals, computers, microelectronics, chemicals, machine tools, aerospace and scientific instruments.

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munity Patent Convention, 27 GEO. WASH. J. INT'L L. & ECON. 501 (1994) (arguing for the creation of a North American Patent Office to serve the three signatories of NAFTA); *see also* James A. Nafziger, *NAFTA's Regime for Intellectual Property: In the Mainstream of Public International Law*, 19 HOUS. J. INT'L. L. 807, 827 (1997) (noting that "[b]oth the NAFTA and TRIPS enable their parties to provide more extensive protections under domestic law than the multilateral agreements themselves would require"); Sharan L. Goolsby, *Protection of Intellectual Property Rights Under NAFTA*, NAFTA: L. & BUS. REV. AM., Autumn 1998, at 5 (discussing the protection of intellectual property rights under NAFTA).

[64] NAFTA, *supra* note 3, Art. 1710. Integrated circuits are protected in accordance with the IPIC Treaty. *Id.* Art. 1710(1). *See* IPIC Treaty, *supra* note 9. Each party must make it unlawful to import, sell or otherwise distribute for commercial purposes either "a protected layout design, an integrated circuit in which a protected layout design is incorporated[,] or an article incorporating such an integrated circuit," without authorization. NAFTA, *supra* note 3, Art. 1710(2). Perhaps the most significant feature of this provision is that for the first time it will extend the protection of integrated circuits to Mexico. Mexico was granted a four-year grace period during which it must make every effort to comply with the treaty. *Id.* Art. 1710(10).

[65] NAFTA, *supra* note 3, Art. 1711. NAFTA specifically provides that trade secrets shall be protected and that each government shall provide "the legal means for any person to prevent trade secrets from being disclosed to, acquired by, or used by others without the consent of the person lawfully in control of the information in a manner contrary to honest commercial practices." *Id.* Art. 1711(1). In order to be protected, the information must not be generally "known among or readily accessible to persons that normally deal with the kind of information in question[,] the information has actual or potential commercial value because it is secret[,] and the person lawfully in control of the information has taken reasonable steps . . . to keep it secret." *Id.* A Party may also require that "to qualify for protection a trade secret must be evidenced in documents, electronic or magnetic means, optical discs, microfilms, films or other similar instruments." *Id.* Art. 1711(2). Limitations on the duration of protection of trade secrets are prohibited as long as the information is kept secret, derives commercial value, and reasonable steps are taken to keep the information secret. *Id.* Art. 1711(3). NAFTA marks the first time that protection of trade secrets has been codified in an international agreement.

[66] *Id.* Art. 1712. The use or registration of misleading or otherwise unfairly competitive geographical indications is prohibited. *Id.* Art. 1712(1). A geographical indication is any indication that identifies a good as originating in a territory of a Party where a particular quality, reputation or other characteristic of the good is attributed to its geographical location. *Id.* Art. 1712(2).

[67] *Id.* Art. 1713. Independently created industrial designs which are new or original shall be protected. *Id.* Art. 1713(1). The minimum term of protection is 10 years. *Id.* Art. 1713(5).

[68] *See generally* Goolsby, *supra* note 63, at 5 (discussing the protection of intellectual property rights under NAFTA).

One of the stated objectives of NAFTA is to "create effective procedures for the implementation and application of this Agreement, for its joint administration and for the resolution of disputes."[69] NAFTA grants "national treatment" requiring each country to accord nationals of fellow signatories no less favorable treatment than it accords its own nationals in the protection and enforcement of intellectual property rights.[70] Generally, each Party must provide domestic legislation that ensures the fair and equitable enforcement of intellectual property rights and such enforcement procedures must be applied so as to avoid the creation of barriers to trade.[71] The procedures for "the enforcement of intellectual property rights [must be] fair and equitable, not [be] unnecessarily complicated or costly, and not entail unreasonable time-limits or unwarranted delays."[72] The general dispute resolution provisions of NAFTA are also made applicable to intellectual property protection.[73]

Perhaps the most controversial issue regarding NAFTA in the intellectual property area relates to the Cultural Industries Exemption granted exclusively to Canada.[74] Generally, Annex 2106 excludes Canada's "cultural industries" from the NAFTA provisions. The term "cultural industries" is defined as industries engaged in the publishing, distributing or selling of the following: books, periodicals and newspapers; films or videos, audio or video music recordings or printed or machine readable music; public radio communications; radio, television and cable TV broadcasting; and satellite programming and broadcasting network services.[75] With Canada's long history of governmental support of its cultural industries, this exemption was considered critical by Canada in order to protect its cultural sovereignty. This exclusion for cultural industries allows Canada broad

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[69] NAFTA, *supra* note 3, Art. 102(1)(e).

[70] *Id.* Art. 1703. With regard to investors generally, NAFTA provides for "national treatment" and "most-favored-nation treatment" according investors of a Party treatment no less favorable than that accorded to investors of another Party or non-Party country. *Id.* Arts. 1102, 1103. Such treatment does not apply to specific nonconforming measures under the laws of a country in existence at the time the country entered into NAFTA. *Id.* Art. 1108(1).

[71] *Id.* Art. 1714(1). *See generally id.* Arts. 1715-18 (providing for civil and administrative procedures, provisional measures, criminal procedures and penalties, and enforcing intellectual property rights at the border).

[72] *Id.* Art. 1714(2).

[73] *Id.* Annex 2004. Annex 2004 applies the general dispute resolution procedures of Chapter 20 to Chapter 17. *Id.*

[74] *Id.* Annex 2106. "[A]s between Canada and the United States, any measure adopted or maintained with respect to cultural industries, . . . [will] be governed under [the FTA]." *Id.*; FTA, *supra* note 5. The United States reserved the right to retaliate under the FTA. Recently, the United States was also successful in a challenge filed with the WTO regarding measures taken by Canada to protect the Canadian magazine industry. *See* FTA, *supra* note 5, Art. 2005.2; Certain Measures Concerning Periodicals (Canadian Periodicals) at WT/DS31 (March 11, 1996).

[75] FTA, *supra* note 5, Art. 2012.

derogations from NAFTA's intellectual property provisions as well as her obligations under the services[76] and investment chapters.[77]

TRIPS and NAFTA both provide significant protection to intellectual property transferred across international borders. Although only time will tell how well these agreements will ultimately operate in practice, the fact of their negotiated conclusion will provide a critical beacon for cross-border transfers in this area.

B. Trade in Related Services: Access

Trade in technology often includes trade in services in addition to, or exclusive of, the transfer of intellectual property rights. Such trade can occur in a variety of ways, including contact by fax, phone or mail, sending experts to temporarily help in the setup or completion of a project, training the user's employees outside the user's home country, or establishing a permanent commercial presence in the user's country to provide ongoing assistance to the user. Common to most of these avenues is the need for access to the foreign market. Mechanisms for assuring access are addressed in both the General Agreement on Trade in Services ("GATS"),[78] another product of the WTO Agreement, and Chapter 12 of NAFTA.

1. GATS

The GATS accord is one of the first negotiated attempts to establish a multilateral understanding and agreement covering trade and investment in the services sector.[79] The final agreement consists of a framework setting out general multilateral rules governing trade and investment in services.[80] GATS applies to all trade in services[81] and every possible mode of supply.[82]

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[76] NAFTA, *supra* note 3, Ch. 12.

[77] *Id.* Ch. 11.

[78] General Agreement on Trade in Services, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Uruguay Round Final Act, Annex 1B, LEGAL INSTRUMENTS – RESULTS OF THE URUGUAY ROUND vol. 31; 33 I.L.M. 44 (1994) [hereinafter GATS]. *See generally* Romano, *supra* note 23; Laurinda L. Hicks & James R. Holbein, *Convergence of National Intellectual Property Norms in International Trading Agreements*, 12 AM. U. J. INT'L L. & POL'Y 769 (1997) (discussing intellectual property international and regional conventions and treaties).

[79] *See* GATS, *supra* note 78. The Uruguay Round was concluded on December 15, 1993. There are currently 135 signatories. *Id.*

[80] *See generally* Harry G. Broadman, *International Trade and Investment in Services: A comparative Analysis of the NAFTA*, 27 INT'L LAW. 623 (1993) (analyzing the services provisions of NAFTA); Mary E. Footer, *The International Regulation of Trade in Services Following Completion of the Uruguay Round*, 29 INT'L. LAW. 453 (1995) (providing a review of international trade in services after the completion of the Uruguay Round); William C. Yue, *Trade in Services Under GATS and the NAFTA*, 863 PLI/CORP 195, 197 (1994) (noting that GATS "reflect[s] a fundamental change in the world economy").

[81] GATS, *supra* note 78, Art. I(1).

In addition, GATS contains a series of Annexes and understandings providing detailed rules dealing with various types of services such as financial, air transport and maritime transport services, and access to telecommunication networks.[83]

GATS presents a set of general obligations and disciplines applicable to all Members which include "most-favored-nation treatment,"[84] "national treatment,"[85] and "market access."[86] With regards to most-favored-nation treatment, Members are permitted to list exemptions from this requirement.[87] National treatment and market access are negotiated rights under GATS. Under the Schedules of Specific Commitments Articles,[88] Members may specify certain terms, limitations, conditions, and qualifications to the requirements of national treatment and market access;[89] and Members may also negotiate commitments with respect to measures affecting trade in services not subject to Scheduling under the National Treatment Article and Market Access Article.[90] Thus, although GATS provides the legal machinery to eliminate trade barriers against services and services suppliers, each Member may negotiate as to certain obligations. The results of these negotiations are set out as binding obligations of that Member and appended to GATS as a Schedule. "[L]ike tariff negotiations in goods, these multilateral service commitments result from iterative bilateral 'request and offer' negotiations conducted seriatim on a country-by-country basis."[91] GATS further requires impartial administration of domestic regulation,[92] transpar-

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[82] *Id.* Art. I(2).

[83] *See Id.* Art. XXIX.

[84] *Id.* Art. II. "[E]ach member shall accord . . . to services and service suppliers of any other Member treatment no less favourable than that accord[ed] to like services and service suppliers of any other country." *Id.* Art. II(1).

[85] *Id.* Art. XVII. "[E]ach member shall accord to services and service suppliers of any other Member, . . . treatment no less favourable than that it accords to its own like services and service suppliers." *Id.* Art. XVII(1).

[86] *Id.* Art. XVI. "[E]ach member shall accord services and service suppliers of any other Member treatment no less favourable than that provided for under the terms, limitations and conditions agreed and specified in its Schedule." *Id.* Art. XVI(1). Article XVI(2) lists six types of prohibited discriminatory measures that governments frequently impose to limit competition. *Id.* Art. XVI(2). However, if the measure is listed in the government's Schedule, the measure will not be prohibited. *Id.* Art. XX.

[87] Id. Art. II(2). The inconsistent measure must be listed in, and meet the conditions of, the Annex on Article II exemptions. *Id.*

[88] *Id.* Art. XX(1).

[89] *Id.* "A Member . . . may modify or withdraw any commitment in its Schedule, at any time after three years . . . from the date [the] commitment entered into force." *Id.* Art. XXI(1).

[90] *Id.* Art. XXI(2)(a).

[91] Broadman, *supra* note 80, at 631-32.

[92] GATS, *supra* note 78, Art. VI.

ency,[93] discipline on public monopolies,[94] recognition of other Members' regulatory schemes,[95] and the provision of consultation procedures on competition matters.[96] Finally, GATS allows exceptions from its provisions for national security,[97] safety and health, and the enforcement of tax laws.[98]

2. *NAFTA*

The basic rules that Canada, Mexico and the United States must observe in regulating cross-border services are contained in Chapter 12 of NAFTA. With regard to certain types of services, other Chapters contain provisions that regulate the furnishing of services across border: investment,[99] telecommunications,[100] financial services,[101] and temporary entry for business people.[102] These Chapters are complimented by Annexes, including land transportation,[103] professional services,[104] and specific reservations and exceptions.[105]

Chapter 12 of NAFTA applies to all the laws and regulations of a Party relating to cross-border trade in services by the service providers of another Party.[106] Included within Chapter 12 are measures respecting: (a) the production, distribution, marketing, sale and delivery of a service; (b) the purchase or use of, or payment for, a service; (c) the access to and use of distribution and transportation systems in connection with the provision of a service; (d) the presence in its territory of a service provider of another Party; and (e) the provision of a bond or other form of financial security as a condition for the provision of a service.[107]

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[93] *Id.* Art. III. Each member must promptly publish all matters relevant to this Agreement. *Id.* Art. III(1).

[94] *Id.* Art. VIII.

[95] *Id.* Art. VII.

[96] *Id.* Art. IX.

[97] *Id.* Art. XIV(1) *bis*.

[98] *Id.* Art. XIV.

[99] NAFTA, *supra* note 3, at Ch. 11.

[100] *Id.* Ch. 13.

[101] *Id.* Ch. 14.

[102] *Id.* at Ch. 16. To facilitate access to other signatory countries, NAFTA establishes the principle that business persons of one country who fall in any 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. Specific rules were enacted to achieve this purpose. *Id.* Annex 1603.

[103] *Id.* Annex 1212.

[104] *Id.* Annex 1210.5.

[105] *Id.* Annex 2106 (exempting Canadian Cultural Industries); *see also supra* text accompanying note 5 (defining "cultural industries" under the FTA).

[106] *See generally* Yue, *supra* note 80, at 195 (discussing trade in services under NAFTA).

[107] NAFTA, *supra* note 3, Art. 1201(1). Chapter 12 does not apply to financial services, as defined in Chapter 14 (Financial Services), or air transportation and support services, other than aircraft repair, maintenance services and specialty air services. *Id.* Art. 1201(2).

The Cross-Border Trade in Services Article of NAFTA calls for non-discriminatory treatment in the form of "national treatment"[108] and "most-favored-nation treatment"[109] provisions, whichever is most favorable.[110] It also prohibits a Party from requiring a local presence to be established "in its territory as a condition for the cross-border provision of a service."[111] Moreover, the NAFTA signatories may make specific "reservations" for existing laws and regulations that fail to conform to the requirements of national treatment, most-favored-nation treatment, and local presence.[112] The non-conforming measures listed as a reservation cannot be challenged as long as they do not become more inconsistent with NAFTA.[113] Further, the Parties are obligated to guarantee that licensing and certification procedures are fair and impartial and that such procedures are designed to ensure their competence and to avoid unnecessary trade barriers.[114] Chapter 12 requires the elimination of citizenship and permanent residency requirements with respect to the licensing of professionals.[115] Quantitative restrictions are to be disclosed and the signatories are required to endeavor periodically to negotiate the liberalization or removal of such restrictions.[116] A Party may refuse, under certain circumstances, to apply the protections of Chapter 12 to the nationals or enterprises of any NAFTA signatory with which it does not have diplomatic relations or to which it is applying sanctions.[117]

Overall, NAFTA is designed to significantly liberalize trade in services by providing for common licensing rules, transparency provisions, dispute resolution procedures, and the automatic inclusion of new services. As will be seen, however, the removal of nontariff barriers to trade in services through worldwide or regional trade agreements does not alter the potentially discriminating provisions contained in the double taxation agreements of the signatory countries or affect the right to discriminate when taxing in-

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Chapter 12 also does not require a Party to provide individuals from other Party countries access to their labor market. *Id.* Art. 1201(3).

[108] *Id.* Art. 1202. "[E]ach Party shall accord to service providers of another Party treatment no less favorable than that it accords . . . to its own service providers." *Id.* Art. 1202(1).

[109] *Id.* Art. 1203. "[E]ach Party shall accord to service providers of another Party treatment no less favorable than that it accords . . . to service providers of [another] Party or of a non-Party." *Id.*

[110] *Id.* Art. 1204.

[111] *Id.* Art. 1205.

[112] *Id.* Art. 1206(1)(a). Each Party must set out any existing non-conforming measure in its Schedule to Annex I. *Id.*

[113] *Id.* Art. 1206(1)(c).

[114] *Id.* Art. 1210(1).

[115] *Id.* Art. 1210(3).

[116] *Id.* Art. 1207. Each Party must list any quantitative restriction on its Schedule to Annex V. *Id.*

[117] *Id.* Art. 1211.

come earned within that country. Nevertheless, issues of income taxation generally remain regulated solely by tax treaties.[118]

III. DIRECT TAXATION AND TRADE AGREEMENTS

A. The Role of Tax Treaties

The primary goal of the WTO Agreement and NAFTA is to stimulate cross-border trade and cross-border investment by regulating both tariff and nontariff barriers to trade. However, income taxes, for the most part, are carved out of the protections provided under these agreements, and left, instead, to the provisions of bilateral income tax treaties. Nevertheless, income taxes can have just as deleterious an effect on cross-border trade and cross-border investment as tariffs and other barriers. Specifically, the threat of double taxation can effectively deter market entry. Bilateral tax treaties are designed to prevent such tax barriers.[119]

This important role of tax treaties in cross-border trade has been recognized by the countries in the NAFTA block. Mexico entered bilateral double taxation agreements with both Canada[120] and the United States[121] almost concurrently with the signing of NAFTA. Changes were also made to the Canada-U.S. Tax Treaty[122] in the form of the 1995 Protocol which was de-

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[118] *See infra* Part IV (discussing the relevant tax treaties).

[119] One of the most important protections tax treaties provide is the prevention of discrimination against foreign nationals, individual or corporate, or domestic entities whose capital is owned by foreign nationals. Nevertheless, payments of periodic income, like dividends, interest, or royalties may be treated differently for tax purposes depending on whether they are paid to residents or non-residents. This is true because countries typically tax residents on their worldwide income, allowing deductions for costs, but tax non-residents earning periodic income on their gross income without deductions. Double taxation occurs where both the source country and the resident country claim taxing rights over the same income. Generally, relief from double taxation is granted by the country of residence by allowing a credit for the foreign tax paid. For example, the United States provides unilateral relief from many instances of double taxation by the provision of a foreign tax credit on income earned in a foreign country. I.R.C. § 901(a) (1999). *See generally* Philip D. Morrison, *The U.S.-Mexico Tax Treaty: Its Relationship to NAFTA and Its Status*, 1 U.S.-MEX. LAW J. 311 (1993) (discussing the relationship of the U.S.-Mexico Tax Treaty to NAFTA).

[120] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Apr. 8, 1991, Can.-Mex., *reprinted in* 2 CANADA'S TAX TREATIES 15271 (Butterworths 1992) [hereinafter Mexico-Canada Treaty]; Protocol to the Convention, Apr. 8, 1991, Can.-Mex., 2 CANADA'S TAX TREATIES 15271 (Butterworths 1992) [hereinafter Mexico-Canada Treaty, 1991 Protocol].

[121] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, with Protocol, Sept. 18, 1992, U.S.-Mex., S. Treaty Doc. No. 103-07, *reprinted in* 3 TAX TREATIES (CCH) ¶ 5903 [hereinafter U.S.-Mexico Treaty]; Additional Protocol to the Convention, Sept. 18, 1992, U.S.-Mex., *reprinted in* 3 TAX TREATIES (CCH) ¶ 5904 [hereinafter U.S.-Mexico, 1992 Protocol].

[122] Convention Between the United States of America and Canada with Respect to Taxes on Income and Capital, Sept. 26, 1980, U.S.-Can., T.I.A.S. No. 11,087, at 2 [hereinafter

signed to promote close economic cooperation between the United States and Canada by adding protections against "treaty shopping," strengthening levels of cooperation between the tax authorities of the two countries, and minimizing certain barriers to trade caused by overlapping tax jurisdictions.[123]

In addition to the tax treatment of payments for transfers of technology and related services, tax treaties raise, and are beginning to address, other important issues. The interaction of the three bilateral tax treaties with NAFTA in direct taxation matters, particularly with respect to national treatment and most-favored-nation treatment obligations, will prove important in cross-border trade. Issues are also emerging as to the interpretation and application of certain provisions in the 1995 Protocol to the Canada-U.S. Treaty[124] which specifically addressed GATS. Finally, tax treaties reflect the country's general policies toward cross-border trade. For example, a continued barrier to trade in technology exists in the form of a withholding tax on a wide range of cross-border payments for intellectual property rights. The tax treaties, thus, are an important factor in considering potential impediments to cross-border trade in technology.

The immediate discussion focuses on the provisions in NAFTA that refer to taxation and tax treaties, and is followed by a similar discussion with regard to GATS. An examination of each of the tax treaties and their potential role in WTO disputes under GATS follows.

B. NAFTA

The principal provisions in NAFTA relating to taxation are in found in Article 2103 which states that "[e]xcept as set out in this Article, nothing in this Agreement shall apply to taxation measures."[125] Further, NAFTA will not affect the rights and obligations of a Party under any tax treaty and, in the event of any inconsistencies between NAFTA and the provisions of any tax treaty, the provision of the tax treaty will prevail.[126] Thus, disputes on

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Canada-U.S. Treaty]; Protocol Amending the 1980 Tax Convention, June 14, 1983, T.I.A.S. No. 11,087, at 63 [hereinafter Canada-U.S. Treaty, 1983 Protocol]; Protocol Amending the 1980 Tax Convention, Mar. 28, 1984, U.S.-Can., *reprinted in* 1 TAX TREATIES (CCH) ¶ 1942 [hereinafter Canada-U.S.Treaty, 1984 Protocol]; Protocol Amending the 1980 Tax Convention, Mar. 17, 1995, U.S.-Can., *reprinted in* 1 TAX TREATIES (CCH) ¶ 1946 [hereinafter Canada-U.S. Treaty, 1995 Protocol]; Protocol Amending the 1980 Tax Convention, July 29, 1997, U.S.-Can., *reprinted in* 1 TAX TREATIES (CCH) ¶ 1949A [hereinafter Canada-U.S. Treaty, 1997 Protocol].

[123] Letter of Submittal to the President of the United States, Department of State, April 12, 1995, *reprinted in* 1 TAX TREATIES (CCH) ¶ 1947.

[124] Canada-U.S. Treaty, 1995 Protocol, *supra* note 122, Art. 17. *See infra* notes 153-160 and accompanying text (discussing the interaction between the Canada-U.S. Treaty and GATS).

[125] NAFTA, *supra* note 3, Art. 2103(1).

[126] *Id.* Art. 2103(2).

tax matters covered by the tax treaties are to be resolved exclusively under the tax treaty provisions.

Under NAFTA, existing and future tax measures affecting trade in goods are subject to provisions requiring national treatment and such other provisions as are necessary to give effect to NAFTA.[127] These provisions apply despite the existence of a tax treaty and are designed to prevent, for example, discriminatory sales taxes on imported products. With regard to the trade in goods, a Party may not adopt or maintain any duty, tax or other charge on the export of any good to another Party, unless such duty, tax or other charge is imposed on the exports of all other Parties and destined for domestic consumption.[128]

NAFTA also clarifies that the national treatment and most-favored-nation treatment provisions in the investment, services, and financial services chapters will apply to all taxation measures other than income, capital gains, capital, estates, gifts, inheritances and generation-skipping transfers, and certain other listed taxes including the Mexican assets tax.[129] Thus, national treatment and most-favored-nation treatment will apply to provincial and state sales taxes. Even these obligations, however, are limited by a number of important exceptions. First, NAFTA's most-favored-nation treatment provisions do not prevent a NAFTA signatory from providing an exclusive bilateral advantage under a tax treaty to a specific treaty partner.[130] Second, the NAFTA provisions do not apply to the continuation or renewal of any non-conforming taxation measures in existence at the time that NAFTA went into effect, or any amendment to a taxation measure that does not increase its non-conformity.[131] Third, a broadly drafted exclusionary clause was 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."[132]

The income taxation of trade in services and financial services is disciplined to some extent by NAFTA's national treatment provisions. Specifi-

[127] *Id.* Art. 2103(3)(a). Specifically, the Article provides that it shall apply to tax measures to the same extent as does Article III of GATT 1994. Article III of GATT 1994 contains the national treatment obligation which applies to domestically produced goods and imported goods. GATT 1994, *supra* note 4, Art. III(1). Article III(1) states that internal taxes and laws "should not be applied to imported or domestic products so as to afford protection to domestic production." *Id.* Art. III(1). Article III(2) focuses on internal taxes and changes. *Id.*, Art. III(2).

[128] NAFTA, *supra* note 3, Art. 2103(3)(b). Similar restrictions apply to exports of Energy and basic petrochemicals. *Id.*

[129] *Id.* Art. 2103(4)(b). The asset tax under the Asset Tax Law of Mexico, *Ley del Impuesto al Activo*, is included in the exclusions. *Id.* Annex 2103.4(1).

[130] *Id.* Art. 2103(4)(c).

[131] *Id.* Art. 2103(4)(d)-(f).

[132] *Id.* Art. 2103(4)(g).

cally, the national treatment provision will apply to all taxation measures on income, capital gains, or the taxable capital of corporations, and to certain listed taxes relating to the purchase or consumption of particular services.[133] The purpose of this provision was to prevent a Party's tax law from providing, for example, for the deduction of the cost of consulting services purchased from a domestic consulting firm but not from consulting firms of other NAFTA signatories.[134]

The two remaining NAFTA measures that potentially apply to tax measures include provisions prohibiting performance requirements[135] and provisions preventing the expropriation of property.[136] With regard to investments, the provisions prohibiting performance requirements will also apply to taxation measures.[137] This requirement is intended to prevent a government 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.[138] Seemingly, this prohibition would not prevent a government from conditioning receipt of a tax advantage to requirements such as locating production, performing services, training or employing workers, constructing or expanding facilities or carrying out research and development in its territory.[139] Finally, NAFTA prohibits the use of taxation measures directly or indirectly to nationalize or expropriate an investment owned by a NAFTA signatory unless specified conditions are met, including the payment of compensation. Expropriation claims by an aggrieved investor must first be referred to the Competent Authority pursuant to the tax treaty provisions for resolution before becoming subject to the NAFTA arbitration procedure.[140]

In summary, NAFTA has little impact on the domestic tax laws of the NAFTA signatories and the three bilateral tax treaties entered into by the NAFTA partners. Thus, the tax laws of the signatories, disciplined only by

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[133] *Id.* Art. 2103(4)(a). The asset tax under the Asset Tax Law of Mexico, *Ley del Impuesto al Activo*, is included. *Id.* Annex 2103.4(1).

[134] *See* NAFTA Implementation Act, Pub. L. No. 103-182, 107 Stat. 2057 (1993).

[135] NAFTA, *supra* note 3, art 2103(5).

[136] *Id.* Art. 2103(6).

[137] *Id.* Art. 2103(5).

[138] *Id.* Art. 1106(3)-(5).

[139] *See* BARRY APPLETON, NAVIGATING NAFTA: A CONCISE GUIDE TO THE NORTH AMERICAN FREE TRADE AGREEMENT 83 (1994) (providing a guide for navigating through NAFTA's provisions).

[140] NAFTA, *supra* note 3, Art. 2103(6); Annex 2103.6. The U.S. Competent Authority is the Assistant Secretary of the Treasury, Department of the Treasury. *Id.* Annex 2103.6(c). The Assistant Deputy Minister for Tax Policy, Department of Finance, is the Competent Authority in Canada. *Id.* Annex 2103.6(a). In Mexico, the Deputy Minister of Revenue of the Ministry of Finance and Public Credit, *Secretaria de Hacienda y Credito Publico*, is the authorized Competent Authority. *Id.* Annex 2103.6(b).

their bilateral income tax treaties, continue as a major barrier to cross-border trade of technology and related services within the NAFTA block.

C. The WTO Agreement and Tax Treaties

1. GATS

Although many aspects of negotiating GATS were contentious, the method of enforcement of direct income tax laws, in particular, became a major issue in the final days of the Uruguay Round. The United States strongly opposed the inclusion of direct taxes in the national treatment requirements under GATS. It was the view of the United States that such matters should be resolved under the bilateral tax treaties.[141]

GATS in its final form reflects a compromise. Under the agreement, the Non-Discrimination Articles in existing bilateral tax treaties will have primacy over the National Treatment Article of GATS.[142] In particular, a Member may not invoke the national treatment provisions of GATS under the Consultation Article[143] or Dispute Settlement and Enforcement Article,[144] with respect to a measure of another Member that falls within the scope of a bilateral double taxation agreement. In the case of disagreement as to whether a measure falls within the scope of such an agreement, either Member may unilaterally bring the matter before the Council for Trade in Services.[145] If the double taxation agreement was in existence on the date the WTO Agreement entered into force, however, both Members must consent before a matter may be brought before the Council.[146] The Council will then refer the matter to binding arbitration.[147]

The provisions in GATS which relate directly to the tax treatment of services provide that any Member may adopt or enforce direct tax measures which are inconsistent with national treatment. However, any such inconsistent measures must not be applied in a manner which constitutes a means of "arbitrary or unjustifiable discrimination" in trade or services and must be "aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members."[148] The meaning of "equitable or effective" is defined in a footnote which pro-

[141] *See* Tycho H.E. Stahl, *Liberalizing International Trade in Services: The Case for Sidestepping the GATT*, 19 YALE J. INT'L L. 405, 429 (1994) (noting that "[f]or years, the United States and other [developed countries] have sought to introduce services trade liberalization talks into the GATT framework").

[142] GATS, *supra* note 78, Art. XXII(3).

[143] *Id.* Art. XXII.

[144] *Id.* Art. XXIII.

[145] *Id.* Art. XXIV.

[146] *Id.* Art. XXII(3) n.12.

[147] *Id.* Art. XXII(3).

[148] *Id.* Art. XIV(d).

vides illustrations of taxes and tax policies, including the right to impose a withholding tax, that may be excluded from national treatment requirements.[149] The GATS agreement also provides for an exemption from the most-favored-nation treatment if the "difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which the Member is bound."[150]

2. *The Canada-U.S. Treaty*

The relationship between NAFTA and the double taxation agreements of the NAFTA signatories is provided for within the NAFTA provisions.[151] TRIPS[152] is silent as to tax matters. The tax treaties entered into among the NAFTA signatories are likewise silent with regards to NAFTA and TRIPS; nevertheless, the Canada-U.S. Treaty[153] does address the potential role of GATS[154] in resolving tax matters.

The 1995 Protocol amended the Canada-U.S. Treaty to include new provisions for purposes of the application of Article XXII(3) of GATS.[155] Generally, Article XXII(3) of GATS provides that the Non-Discrimination Article of a double taxation agreement has supremacy over the National Treatment Article of GATS, with regard to a measure that falls within its scope. If there is a question of whether a matter falls within the scope of the tax treaty which was in existence at the time the WTO Agreement en-

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[149] *Id.* Art. XIV(d) n.6. The footnote states:

> 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. [The] [t]ax terms or concepts in [the exception] and in this footnote are determined according to tax definitions and concepts, or equivalent . . . under the domestic law of the Member taking the measure.

Id.

[150] *Id.* Art. XIV(e).

[151] NAFTA, *supra* note 3, Art. 2103.

[152] TRIPS, *supra* note 21.

[153] Canada-U.S. Treaty, *supra* note 122.

[154] GATS, *supra* note 78.

[155] Canada-U.S. Treaty, 1995 Protocol, *supra* note 122, Art. 17(2).

tered into force, one country cannot unilaterally challenge the issue of the tax treaty's scope under the GATS procedures. However, if a tax treaty is subsequently ratified, either treaty partner may unilaterally bring the question of the tax treaty's scope to the Council for Trade in Services which will then refer the matter to binding arbitration.[156]

The amendment to the Canada-U.S. Treaty provides that, for the purposes of GATS, Canada and the United States agree that a tax measure falls within the scope of the Canada-U.S. Treaty[157] only if it relates to a tax to which Article XXV (Non-Discrimination) applies or, if it does not relate to such a tax, it falls within another tax treaty provision, but only to the extent that the tax measure relates to a matter dealt within that tax treaty provision. The Canada-U.S. Treaty also clarifies that despite Article XXII(3) of GATS, any doubt as to the interpretation of the scope of a treaty provision and, specifically, whether the Canada-U.S. Treaty applies, will be resolved under paragraph three of Article XXVI (Mutual Agreement Procedure) of the Canada-U.S. Treaty.[158]

The 1995 Protocol to the Canada-U.S. Treaty which limits the role of the WTO in tax disputes was of no surprise given the strong position taken by the United States during the Uruguay Round to the inclusion of direct taxes in the national treatment requirement under GATS.[159] The compromise result was subjecting the issue of national treatment, at least with respect to the direct taxation of service income, to the non-discrimination provisions in the Canada-U.S. Treaty.[160]

3. *Mexico-Canada and U.S.-Mexico Treaties*

The Mexico-Canada Treaty[161] and U.S.-Mexico Treaty[162] were both signed in 1992 prior to the final negotiation of the WTO Agreement and NAFTA. Thus, neither TRIPS, GATS nor NAFTA are mentioned in those treaties. As both treaties were entered into prior to the signing of the GATS agreement, the GATS default provisions will apply and the Non-Discrimination Articles in the tax treaties will have primacy over GATS national treatment provision. As a result, if there is disagreement about

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[156] GATS, *supra* note 78, Art. XXII(3).

[157] *See* Canada-U.S. Treaty, 1995 Protocol, *supra* note 122, Art. 17(2) (amending paragraph 6 of Article XXIX (Miscellaneous Rules) of the Convention).

[158] *Id.*

[159] *See* Stahl, *supra* note 141, at 429 (noting that the U.S. made it clear during negotiations that the WTO should not have the right to intervene where a government was alleged to have violated national treatment provisions when the direct taxation of services was at issue).

[160] *See infra* Part IV.B.8 (discussing Article XXV (Non-Discrimination) of the Canada-U.S. Treaty).

[161] Mexico-Canada Treaty, *supra* note 120.

[162] U.S.-Mexico Treaty, *supra* note 121.

whether the matter falls within the scope of the tax treaty, one country cannot unilaterally challenge that issue under GATS procedures.[163]

IV. TAX TREATIES

As neither the WTO Agreement nor NAFTA adequately address taxation as a barrier to cross-border trade, the elimination of double taxation as a barrier is left to the bilateral tax treaties. Although the elimination of double taxation is the primary function of tax treaties, with the complexity and fluidity of each country's domestic tax laws and competing national social and economic agendas, this objective has not been achieved and double taxation is a real possibility with every cross-border transfer of technology and related services. Therefore, before such an agreement is reached, a tax advisor must closely examine the domestic tax law of each country involved in a transaction and the impact of the double taxation agreement involved. Further, within the NAFTA block, the bilateral tax treaties among the NAFTA signatories contain critical differences with respect to the taxation of the treaty partners. For example, a U.S. taxpayer who receives royalty payments from a Mexican source may encounter different tax treatment than a Canadian taxpayer in identical circumstances. These differences in tax treatment between the NAFTA signatories cannot be ignored when considering the tax issues associated with the cross-border transfer of intellectual property and related services, and will place considerable pressure on tax advisors in planning for future cross-border activities.[164]

Generally, the tax treaties of the NAFTA signatories are patterned on the Organization for Economic Cooperation and Development's Model Treaty ("OECD Model").[165] Specifically, the current version of the Can-

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[163] GATS, *supra* note 78, Art. XXII(3).

[164] Many free trade advocates argue the free trade policy requires that there should be greater tax free treatment of cross-border reorganizations: business structures must change in response to international business needs and tax impediments should not prevent free trade and capital mobility. *See* Brian J. Arnold & Neil H. Harris, *NAFTA and the Taxation of Corporate Investment: A View From Within NAFTA*, 49 TAX L. REV. 529, 559-76 (1994) (discussing tax considerations in the structure of new foreign investments by Canadian multinational corporations); *see also* Paul R. McDaniel, *Formulary Taxation in the North American Free Trade Zone*, 49 TAX L. REV. 691, 699 (1994) (arguing that there is a need to reexamine existing tax treaties and legislation once a regional free trade zone has been created). It is not the position of the authors that trade policy should necessarily dictate tax policy, but rather, our position recognizes that changes in trade policy may have created a need to review the current treaty system to determine whether it adequately addresses this problem.

[165] Committee on Fiscal Affairs, Organization for Economic Cooperation and Development, Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital of the Organization for Economic Cooperation and Development, (1977) [hereinafter OECD Model]. The OECD Model was revised in 1992 and subsequently updated in 1994, 1995 and 1997. Committee on Fiscal Affairs, Organization for Economic

ada-U.S. Treaty[166] was negotiated on the basis of the OECD Model with a number of deviations in order to address both the particular features of Canadian and U.S. tax law, as well as the unique economic relationship of Canada and the United States.[167] The current Canada-U.S. Treaty, which was signed in 1980, has been the subject of four subsequent protocols, the latest being signed in July of 1997.[168] The 1995 Protocol, signed in March of 1995, includes an amendment in direct response to GATS.[169]

The tax treaty between Canada and Mexico with protocol, which entered into force on May 11,1992,[170] was the first bilateral tax treaty signed by Mexico. As with the Canada-U.S. Treaty, the Mexico-Canada Treaty is generally patterned on the OECD Model; however, in recognition of Mexico's status as a developing country, it also borrows from the United Nations' Model Treaty ("U.N. Model"),[171] to recognize and counter the imbalance in investment flow between the two treaty partners.[172]

The tax treaty between the United States and Mexico with a contemporaneous protocol was signed on September 18, 1992,[173] as part of the overall negotiations of NAFTA. Subsequently, the 1992 Protocol expanded the scope of the exchange of information provision[174] of the treaty to include all

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Cooperation and Development Report on Model Double Taxation Convention on Income and on Capital (1995).

[166] Canada-U.S. Treaty, *supra* note 122.

[167] Letter of Submittal to the President of the United States, Department of State, October 16, 1980, *reprinted in* 1 TAX TREATIES (CCH) ¶ 1937. "Since the United States entered into its first income tax treaty with France in the 1930s," the United States has always based its tax treaties on unofficial models developed by the Treasury Department. *See* PETER H. BLESSING, INCOME TAX TREATIES OF THE UNITED STATES ¶ 1.02[4] (1999). In 1976, the Treasury Department published the first model treaty "which followed the 1963 OECD Model Treaty in both structure and terminology. The 1976 U.S. Model was revised in 1977 after the publication of the 1977 OECD Model to ensure continued conformity." *Id.* The U.S. Model was modified and republished in 1981 and again in 1996 with an accompanying Technical Explanation. U.S. Model Income Tax Convention of September 20,1996: Technical Explanation, *reprinted in* HIGHLIGHTS & DOCUMENTS, Sept. 23, 1996, at 3630 [hereinafter U.S. Model].

[168] Canada-U.S. Treaty, *supra* note 122.

[169] Canada-U.S. Treaty, 1995 Protocol, *supra* note 122, Art. 17(2).

[170] Mexico-Canada Treaty, *supra* note 120.

[171] DEPT. OF INT'L ECONOMICS & SOCIAL AFFAIRS, U.N. MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 (1980) [hereinafter U.N. Model].

[172] Developing countries must balance between "the need to attract and keep foreign capital and technology by selectively reducing source-based taxation and . . . the need for governmental revenues." BLESSING, *supra* note 167, at ¶1.02[3][b]. Generally, the U.N. Model accomplishes these objectives over the OECD Model and the U.S. Model. *See id.* at ¶1.02[3][b][i].

[173] U.S.-Mexico Treaty, *supra* note 121.

[174] *Id.* Art. 27.

taxes imposed by the signatories, including state and local taxes.[175] The U.S.-Mexico Treaty also draws from the OECD Model and the U.N. Model, the latter in recognition of Mexico's developing country status.[176]

A. OECD Model

The OECD Model[177] provides Members a basis for the negotiation of double taxation agreements between countries. The stated purpose of the OECD Model is as follows:

> International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods. Its harmful effects on the exchange of goods and services and movements of capital, technology and persons, are so well known that it is hardly needed to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries.[178]

As most countries include the worldwide income of their residents in their tax base, the OECD Model is designed to allocate taxing jurisdiction between signatories and to provide relief where double taxation occurs. In order to accomplish these objectives, the substantive provisions of the OECD Model, generally, allocate to the source country the right to tax gains from the alienation of immoveable property situated in that country,[179] and business profits allocable to a permanent establishment carried on in that country.[180] The source country is also entitled to tax dividends[181] and interest,[182] subject to a ceiling, and income from the performance of per-

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[175] U.S.-Mexico Treaty, 1992 Protocol, *supra* note 121, Art. 2.

[176] In the case of developing countries, capital investment flows primarily from the developed country to the developing country with the resulting income benefiting the former. Therefore, the developing country's interest in protecting and broadening source-based taxation must be protected. *See* U.S. TREASURY DEP'T TECHNICAL EXPLANATION OF THE CONVENTION AND PROTOCOL BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED MEXICAN STATES FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME *signed at* Washington on Sept. 18, 1992, Art. 12 *reprinted in* 3 TAX TREATIES (CCH) ¶ 5943 (1999) [hereinafter U.S.-Mex. Treas. Tech. Expl.]. *See* Eric. J. Smith, *The U.S.-Mexico Tax Treaty*, 8 FLA. J. INT'L L. 97, 102 (1993); Barry Michael Cass & Richard E. Andersen, *U.S.-Mexico Treaty Combines Developed and Developing Country Models*, 3 J. INT'L TAX'N 197 (1992) (discussing the U.S.-Mexico Treaty).

[177] OECD Model, *supra* note 165. *See generally* PHILIP BAKER, DOUBLE TAXATION CONVENTIONS AND INTERNATIONAL TAX LAW (2d ed. 1994) (discussing the 1992 OECD Model Tax Convention on Income and on Capital).

[178] BAKER, *supra* note 177, at 67.

[179] OECD Model, *supra* note 165, Art. 6.

[180] *Id.* Art. 7. *See id.* Art. 8 (allocating profits from the operation of ships or aircraft in international traffic exclusively to the country of effective management of the enterprise).

[181] *Id.* Art. 10.

[182] *Id.* Art. 11.

sonal services by an individual if the contact with the source country is sufficient.[183] Provisions of the OECD Model grant to the country of residence the exclusive right to tax certain types of income arising in the other state, royalties[184] and capital gains, with the exception of gains from the alienation of immoveable property and moveable business property of a permanent establishment or a fixed base situated in the source country,[185] and the residual right to tax income not otherwise specifically dealt with in another provision of the OECD Model.[186] To the extent taxing jurisdictions of two signatories overlap, the OECD Model provides two methods, the exemption method[187] and credit method,[188] for the elimination of double taxation.

The prevention of fiscal evasion is another important objective of the OECD Model. Towards this end, the Associated Enterprises Article provides for the reallocation of profits if associated enterprises do not deal with each other on an independent and arm's length basis.[189] The OECD Model also prevents the residents of one Contracting State from being subject to any taxation which is more burdensome than that imposed on the residents of the other Contracting State.[190] In case of a dispute on any matter that gives rise to taxation in a manner that is not in accordance with the terms of the OECD Model, a Mutual Agreement Procedure allows a resident of a Contracting State to present the dispute to the competent authority of that State.[191] Under these provisions, the competent authorities of both Contracting States must attempt to arrive at a satisfactory solution by mutual agreement if an objection made by a taxpayer appears to be justified.[192] Further, the competent authorities of the Contracting States "must exchange such information as is necessary for carrying out the provisions of the [OECD Model] or of the domestic laws of the Contracting States concerning taxes covered by the [OECD Model]."[193]

An important goal in treaty implementation is the common interpretation of the treaty provisions. The Committee on Fiscal Affairs of the OECD produced the first draft convention for the prevention of double taxation in 1963 which was followed by major revisions in 1977 and

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[183] *Id.* Arts. 14-20.

[184] *Id.* Art. 12. "Under the OECD Model, royalties are tax[ed] only in the country of residence of their beneficial owner;" nevertheless, many double taxation conventions provide for source country taxation up to a maximum level. BAKER, *supra* note 177, at 266.

[185] OECD Model, *supra* note 165, Art. 13.

[186] *Id.* Art. 21.

[187] *Id.* Art. 23A.

[188] *Id.* Art. 23B.

[189] *Id.* Art. 9.

[190] *Id.* Art. 24.

[191] *Id.* Art. 25

[192] *Id.*

[193] *Id.* Art. 26.

1992.[194] Both the draft and the two revisions were accompanied by Commentaries prepared by the Committee.[195] With the adoption of the OECD Model in 1992, the Council of the OECD recommended that the governments of Member countries conform to the OECD Model when concluding new or revising existing tax treaties ". . . as interpreted by the Commentaries thereto . . ."[196] Although not binding, the Commentaries are widely accepted as "the standard for negotiating and analyzing treaty provisions and have made significant contributions to the harmonization of the worldwide network of bilateral income tax treaties."[197] Some commentators have gone so far as to argue that by entering a treaty based on the OECD Model, the Contracting States intend that the treaty must be interpreted in conformity with the Commentaries.[198]

Tax treaties are generally interpreted and applied by each country using the principles of the domestic law. The OECD Model provides that where a term is not defined in a particular treaty, the domestic law of the Contracting State applying the tax treaty will control, unless the context in which the term is used requires a definition independent of domestic law.[199] The OECD Model also provides that the competent authorities of the Contracting States may reach agreement on the meaning of a term pursuant to the Mutual Agreement Procedure where the term is not defined by the treaty.[200] Thus, the domestic law and tax treaty interpretation practices adopted by each country may have a major impact on the final tax result in a cross-border transaction.[201]

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[194] *Id.* The OECD Model adopted in 1992 was subsequently updated in 1994, 1995 and 1997.

[195] *Id.* 1992 OECD Commentary.

[196] Recommendation of the Council dated July 23, 1992, C(92)122/FINAL *cited* in PHILIP BAKER, DOUBLE TAXATION CONVENTIONS AND INTERNATIONAL TAX LAW 3 (2d ed. 1992).

[197] BLESSING, *supra* note 167, at ¶ 1.02[2]. Courts in the United States have used the OECD Commentaries as an aid to interpret international agreements. United States v. A.L. Burbank & Co., 525 F. 2d. 9 (2d Cir. 1975) (referring to the 1975 revised Commentary in connection with the Canada-U.S. Convention of 1942); U.S. v. Lincoln First Bank, 80-1 U.S.T.C. 9, 231 (1980) (referring to the 1973 revised Commentary with respect to the Norway-U.S. Treaty).

[198] *See* D. A. Ward, *Principles To Be Applied in Interpreting Tax Treaties,* 25 CAN. TAX J. 263, 264 n.3 (1977) (arguing that the Commentary should be used if Canada has not recorded disagreement by making a specific reservation to the Commentary).

[199] OECD Model, *supra* note 165, Art. 3(2).

[200] *Id.* Art. 25(3).

[201] Tax treaties provide a degree of certainty regarding the tax rules that apply to cross-border investments. Nevertheless, the possibility of tax legislation preempting provisions of a tax treaty continues to exist. Under the U.S. Constitution, federal treaties and statutes are both considered the supreme law of the land. U.S. CONST., Art. VI, cl. 2. As both treaties and federal statutes have equal force under federal law, a rule to establish primacy in such cases of conflict is necessary. In the United States, the "last enacted" rule determines primacy in cases of conflict. *See* Chae Chan Ping v. United States, 130 U.S. 581 (1889) (stating the last expression of the sovereign will control). However, the term "treaty override"

B. Tax Treaties of the NAFTA Signatories

Tax treaties impact the taxation of many broad categories of income, such as business profits, dividends, interest, royalties, gains from the alienation of property, and income earned from personal services. With regard to the transfer of technology and related services, the relevant treaty articles will depend on the facts of the particular transfer arrangement. Nevertheless, treaty provisions that will most commonly affect technology transfer arrangements are as follows: Article XII (Royalties); Article VII (Business Profits); Article XIII (Capital Gains); Article V (Permanent Establishment); Article XIV (Independent Personal Service); and Article XV (Dependent Personal Services). In some cases, the provisions contained in Article IX (Associated Enterprises), Article XXV (Non-Discrimination), and Article XXVI (Mutual Agreement Procedure) may also apply.

1. Article XII: Royalties

The Royalties Article in the three bilateral tax treaties entered into by the NAFTA signatories clearly mirrors the significant differences in tax policy among the NAFTA partners with respect to withholding taxes. The United States, as a net exporter of technology, prefers a zero withholding tax rate for royalties in keeping with the OECD Model. Both Canada and Mexico, as net importers of technology, have insisted on a withholding tax for royalties to ensure some host country taxation. The current Canada-U.S. Treaty reflects a compromise between these two NAFTA signatories and, as a result, certain royalty payments are not subject to a withholding tax[202] while other royalty payments are subject to a maximum ten percent

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refers to a situation were domestic legislation overrules provisions of a treaty. Although obliged to give effect to the last enacted rule, the U.S. courts have long applied an interpretive rule "as to give effect to both, if that can be done without violating the language of either." Whitney v. Roberston, 124 U.S. 190, 194 (1888). The Internal Revenue Code provides for the equal status of treaties and statutes whereby a rule of construction prevents the unintentional preemption of treaties. I.R.C. § 7852(d)(1) (2000) (providing that neither a tax treaty nor U.S. tax is entitled to preferential status by reason of being a treaty or law). Legislative history of this provision explains that it was intended to confirm that a treaty obligation can be overridden by a statutory provision enacted later in time. *See* H.R. REP. No.100-1104 (1999), at 12; I.R.C. § 894 (a)(1) (2000) (providing that the Internal Revenue Code "shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer"). Nevertheless, preemption continues to be a potential source of instability. For example, even though the last enacted rule only preempts an existing Internal Revenue Code provision, if that provision is in direct conflict with the subsequently enacted treaty, the increasingly complex provisions of the Internal Revenue Code supplements the treaty with regard to any tax issue not directly addressed by the treaty. Lindsey v. Commissioner, 98 T.C. 672, 676 (1992). As a result, the hope that tax treaties provide for tax simplification is illusory. *See* Antonio Mendoza, *The U.S. and Mexico Tax Treaty: Long Overdue But Falling Short of Its Potential*, 17 HOUS. J. INT'L L. 27, 34 (1994).

[202] Canada-U.S. Treaty, *supra* note 122, Art. XII(3).

withholding rate.[203] The treaties that both Canada and the United States have signed with Mexico, however, continue to reflect Mexico's status as a developing country and generally follow the U.N. Model[204] in imposing a ten percent gross withholding requirement on all cross-border royalty payments.[205]

The three tax treaties contain many common provisions. For example, the Royalty Article will not apply if the beneficial owner of the royalties carries on, or has carried on, business in the source state through a permanent establishment or has performed independent personal services from a fixed base in the source state, and the royalties are attributable to such permanent establishment or fixed base. Under those circumstances, the provisions of Article VII (Business Profits)[206] or Article XIV (Independent Personal Services)[207] will apply.[208] The Royalties Article of the tax treaties also addresses pricing issues. Specifically, the provisions determine a fair market value equivalent when a "special relationship"[209] exists between the payor and the recipient, and the royalty payments are considered excessive.[210] Under such circumstances, the Royalties Article only applies to the amount that would have been agreed to by the parties as a royalty payment, in the absence of the special relationship, and the balance of the payment is taxed according to the laws of the treaty partners, with due regard to the other provisions of the tax treaty.[211]

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[203] *Id.* Art. XII(2).

[204] *See* U.N. Model, *supra* note 171, Art. 12(2) (allowing a withholding tax of an undetermined percentage to be imposed by the Contracting State in which the royalties arise).

[205] U.S.-Mexico Treaty, *supra* note 121, Art. 12(2); Mexico-Canada Treaty, *supra* note 120, Art. 12(2).

[206] *See infra* Part IV.B.2 (discussing the treatment of business profits).

[207] *See infra* Part IV.B.5 (discussing the treatment of income from independent personal services).

[208] Canada-U.S. Treaty, *supra* note 122, Art. XII(5); Mexico-Canada Treaty, *supra* note 120, Art. 12(5); U.S.-Mexico Treaty, *supra* note 121, Art. 12(4).

[209] OCED, *supra* note 165, 1992 OECD Commentaries. The OECD Commentaries suggest that this expression is broader than related persons in Article IX, which focuses on a control and management test. A special relationship would include for example, relationships by virtue of "blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the royalty." *Id.* at 1992 OECD Commentaries, Art. 12(4), ¶ 23-24.

[210] In the United States, such a relationship may result in the application of I.R.C. § 482. *See* Treas. Reg. § 1.482-1(i)(4)-(5) (1999) (defining "controlled" and "controlled taxpayer" for the purposes of the U.S. transfer pricing provisions). Presumably, a "special relationship" could also trigger the Canadian and Mexican transfer pricing rules or their equivalent. *See infra* Part IV.B.2.c (discussing the United States, Canadian and Mexican transfer pricing rules).

[211] Canada-U.S. Treaty, *supra* note 122, Art. XII(7); U.S.-Mexico Treaty, *supra* note 121, Art. 12(5); Mexico-Canada Treaty, *supra* note 120, Art. 12(7).

Finally, the Royalties Article of the three tax treaties contains a source rule for royalty payments. Generally, "[r]oyalties arising in a Contracting State and paid to a resident[212] of the other Contracting State may be taxed in that other State."[213] Nevertheless, royalties may also be subject to a withholding tax in the Contracting State in which they arise.[214] Under the Royalties Articles, royalties are deemed to arise in the resident state of the payer; however, where the payer, whether a resident or not, has a permanent establishment or a fixed base in a Contracting State in connection with which the liability to pay the royalties is incurred and borne, then such royalties are deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.[215] Royalties are generally considered borne by a permanent establishment or fixed base if deductible in computing the taxable income of the permanent establishment or fixed base.[216] If neither paid by a resident of either State nor incurred and borne by a permanent establishment or fixed base in either State, but the royalty payments relate to the use of, or a right to use, property in one of the Contracting States, then the source will be in the State where the property is used.[217] For example, if a Mexican resident licensed a patent to a resident of Panama for use in the United States, the royalty paid by the Panamanian licensee to the Mexican owner of the patent would be a U.S. source royalty.[218]

Where the three tax treaties diverge significantly is with respect to which royalty payments are subject to a withholding tax. These differences are outlined below.

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[212] Generally, the term "resident" means any person who has a tax liability under the laws of that state "by reason of his domicile, residence, place of management, place of incorporation or any other criterion of a similar nature." Canada-U.S. Treaty, *supra* note 122, Art. IV(1); U.S.-Mexico Treaty, *supra* note 121, Art. 4(1); Mexico-Canada Treaty, *supra* note 120, Art. 4(1)(a).

[213] Canada-U.S. Treaty, *supra* note 122, Art. XII(1); U.S.-Mexico Treaty, *supra* note 121, Art. 12(1); Mexico-Canada Treaty, *supra* note 120, Art. 12(1).

[214] Canada-U.S. Treaty, *supra* note 122, Art. XII(2); U.S.-Mexico Treaty, *supra* note 121, Art. 12(2); Mexico-Canada Treaty, *supra* note 120, Art. 12(2).

[215] Canada-U.S. Treaty, *supra* note 122, Art. XII(6)(a); U.S.-Mexico Treaty, *supra* note 121, Art. (6)(a); Mexico-Canada Treaty, *supra* note 120, Art. 12(6).

[216] U.S.-Mex. Treas. Tech. Expl., *supra* note 176; U.S. TREASURY DEP'T 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 on Sept. 26, 1980, *as amended* by the Protocol *signed at* Ottawa on June 14, 1983, and the Protocol *signed at* Washington on March 28, 1984, Art. XII *reprinted in* 1 TAX TREATIES (CCH) ¶ 1950 (1997) [hereinafter Can.-U.S. Treas. Tech. Expl.].

[217] Canada-U.S. Treaty, *supra* note 122, Art. XII(6)(b); U.S.-Mexico Treaty, *supra* note 121, Art. 12(6)(b). This provision is omitted from the Mexico-Canada Treaty. *See generally* Mexico-Canada Treaty, *supra* note 120, Art. 12 (setting forth the provisions relating to the taxation of royalties).

[218] U.S.-Mex. Treas. Tech. Expl., *supra* note 176, Art. 12.

(a) Canada-U.S. Treaty

Under the Canada-U.S. Treaty, royalties are subject to a ten percent withholding rate.[219] The broad definition of "royalties"[220] is subject to numerous exemptions, thus, selectively reducing the withholding rate to zero.[221] The 1995 Protocol to the Canada-U.S. Treaty expanded the classes of royalties exempt from the withholding of tax by the source country.[222] The Canada-U.S. Treaty defines "royalty" to include:

> Payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including motion pictures and works on film or videotape for use in connection with television), any patent, trademark, design or model, plan, secret formula or process[;] or the use of, or the right to use, tangible personal property[;] or information concerning industrial, commercial, or scientific experience[;] and . . . gains from the alienation of any intangible property or rights described in [the Royalty Article] to the extent that such gains are contingent on the productivity, use or subsequent disposition of such property or rights.[223]

Prior to the signing of the 1995 Protocol, the Canada-U.S. Treaty only exempted from withholding copyright royalties "in respect of the production or reproduction of any literary, dramatic, musical or artistic work," other than certain payments in respect of motion pictures, videotape and similar payments.[224] The 1995 Protocol preserved the exemption for copyright royalties for literary, dramatic, musical or artistic work,[225] specified that payments for the use of, or the right to use, computer software are also exempt,[226] and further exempted "payments for the use of, or right to use, any patent or any information concerning industrial, commercial or scientific experience," other than payments provided in connection with a rental or franchise agreement.[227] Finally, an exemption was added for payments

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[219] Canada-U.S. Treaty, *supra* note 122, Art. XII(2).

[220] *Id.* Art. XII(4).

[221] *Id.* Art. XII(3).

[222] Canada-U.S. Treaty, 1995 Protocol, *supra* note 122, Art. 7(1).

[223] Canada-U.S. Treaty, *supra* note 122, Art. XII(4).

[224] *Id.* Art. XII(3).

[225] Canada-U.S. Treaty, 1995 Protocol, *supra* note 122, Art. XII(3)(a).

[226] *Id.* Art. XII(3)(b). The negotiated exemption of payments for computer software brought a welcome respite in the ongoing conflict between Canada and the United States relating to software payments. Canada's historic position was that payments for the use of software acquired pursuant to a contract that required the source code or program to be kept confidential represented payments for the use of a secret formula or process and, as such, were royalties. *See* Catherine A. Brown, *The Canadian Income Tax Treatment of Computer Software Payments*, 42 CAN. TAX J. 593 (1994) (discussing the tax treatment of computer software payments under Canadian law).

[227] Canada-U.S. Treaty, 1995 Protocol, *supra* note 122, Art. XII(3)(c).

with respect to broadcasting. This exemption only applies if further agreements are reached between Canada and the United States.[228]

The exemption for the use of, or the right to use, "any information concerning industrial, commercial or scientific experience"[229] includes the use of, or right to use, designs, models, plans, secret formulas, or processes, and know-how.[230] Although exempting know-how from the withholding tax was an important step in facilitating cross-border flows of intellectual property, uncertainty exists as to the interpretation and application of the exemption particularly if services are also provided. The Technical Explanation to the Canada-U.S. Treaty states that the term "royalties" does not include management fees, but may include technical services fees "in cases where the fees are periodic and dependent upon productivity or a similar measure."[231] Whether payment for such assistance is included as part of the transfer of know-how, or any other exempted royalty payment, or treated separately under the business profits or personal services articles, will result in significantly different treatment under the tax treaty.[232]

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[228] *Id.* Art. XII(3)(d). This provision was included because Canada was not then prepared to commit to an exemption for broadcasting royalties. The exemption in its current form was included to enable the U.S. Senate to give advice and consent prior to an exemption for broadcasting royalties so that such an exemption could be obtained without awaiting the negotiation of another full protocol. *See* TREASURY DEP'T TECHNICAL EXPLANATION OF THE PROTOCOL AMENDING THE CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND CANADA WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL *signed at* Washington on September 26, 1980, *as amended* by the Protocols *signed on* June 14, 1983, and Mar. 28, 1984, *signed at* Washington on March 17, 1995, Art. 7 *reprinted in* 1 TAX TREATIES (CCH) ¶ 1951 (1997) [hereinafter Can.-U.S. Treas. Tech. Expl. 1995 Protocol] (explaining the amendments to Article XII).

[229] Canada-U.S. Treaty, *supra* note 122, Art. XII(3)(c).

[230] Can.-U.S. Treas. Tech. Expl. 1995 Protocol, *supra* note 228, Art. 7. The Technical Explanation provides that the term "know-how," is defined in paragraph 11 of the Commentary on Article XII of the OECD Model. *Id.* Paragraph 11 of Article 12 of the OECD Commentaries (*quoting* the Association des Bureaux pour la Protection de la Propriete Industrielle) provides a definition of "know-how" as follows:

> [K]now-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique.

[231] Can.-U.S. Treas. Tech. Expl., *supra* note 216, Art. XII.

[232] The reduction of withholding tax to zero for some royalty payments will place significantly more importance on distinguishing between payments for the transfer of services and intangibles. For example, to the extent that withholding tax on royalties is payable, this is based on the gross payment. Conversely, services are taxed to a greater extent on a net basis. Second, services of an independent profession are only taxable to the extent they are attributable to a fixed base in the host country. Royalties will be subject to withholding regardless of this lack of a permanent presence. Third, the OECD recommendation for the allocation of costs is that these be allocated to the permanent establishment without any mark-up, particularly where the main activity of the permanent establishment is to provide such services. Finally, but not insignificantly, the U.S. transfer pricing rules differentiate between goods

In addition to the challenge of distinguishing royalty payments from other types of payments, such as payments for services, an exempt royalty payment must be distinguished from a royalty payment which is not exempt from the withholding tax. For example, trademarks and trade names were not exempted from taxation by the 1995 Protocol. Additionally, the fact that some royalty payments are exempt and some are non-exempt is likely to operate to the detriment of taxpayers in longstanding licensing arrangements with Canadian or United States licensees. Since there was no need to carefully differentiate between royalty payments prior to the 1995 Protocol, existing licensing arrangements were unlikely to have accurately reflected an apportionment of the total payments between exempt and non-exempt royalties. Attempts to now allocate or reallocate as a result of the Protocol may be viewed with some skepticism by both Revenue Canada and the Internal Revenue Service.[233]

(b) U.S.-Mexico and Mexico-Canada Treaties

The U.S.-Mexico Treaty[234] and the Mexico-Canada Treaty[235] both provide that royalties are subject to a ten percent withholding tax. Generally, the term "royalties" includes payments of any kind received for the use of, or the right to use, any copyright of literary, artistic, or scientific work, including motion picture films and works on film or tapes or other means of reproduction for use in connection with television; any patent, trademark, design or model, plan, secret formula or process, or other like right or property; or information concerning industrial, commercial, or scientific experience as well as for the use of, or the right to, use industrial, commercial or scientific equipment. The term "royalty" also includes gains from the alienation of any such right or property which are contingent on the productivity, use or disposition.[236] The term "copyright" in the U.S.-Mexico

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and services and may significantly affect the overall tax result. *See* Catherine A. Brown, *The 1995 Canada-US Protocol: The Scope of the New Royalty Provision*, 43 CAN. TAX. J. 592 (1995).

[233] *See generally id.* (analyzing the impact of the new royalty provision of the Canada-U.S. Treaty).

[234] U.S.-Mexico Treaty, *supra* note 121, Art. 12(2).

[235] Mexico-Canada Treaty, *supra* note 120, Art. 12(2). In the treaty between Mexico and Canada the negotiated treaty rate was 15%. The Protocol, signed contemporaneously with the tax treaty, provided that if Mexico agreed with any OECD member to a rate of withholding on royalties and interest of less then 15%, then the lower rate, but not a rate lower then 10%, would apply in the Mexico-Canada Treaty. As the U.S. treaty with Mexico provided for a 10% rate, the Protocol rate became effective and the withholding rate on royalties and interest between Canada and Mexico was reduced from 15% to 10%. *See* Mexico-Canada Treaty, 1991 Protocol, *supra* note 120 (providing that Mexico agreed to a tax rate on interest or royalties lower than 15%).

[236] U.S.-Mexico Treaty, *supra* note 121, Art. 12(3); Mexico-Canada Treaty, *supra* note 120, Art. 12(4).

Treaty is "understood to include the use or right to use computer software programs and sound recordings."[237] Point 11 of the contemporaneous Protocol to the U.S.-Mexico Treaty further "clarifies that the reference to 'information concerning industrial, commercial or scientific experience' [will be defined] in accordance with [P]aragraph 12 of the Commentary [to] Article XII of the OECD Model, which distinguishes between information as embodied in know-how and the performance of technical services."[238]

The Royalties Article of the Mexico-Canada Treaty carves out an important exception from the withholding tax for cultural, dramatic, musical or other artistic work. It provides that copyright royalties and other such payments in respect to the production or reproduction of cultural, dramatic, musical or other artistic work will not be taxed in the source state if paid to a resident of the other state who is subject to the tax. This exception does not include "royalties in respect of motion picture films and works on film or videotape or other means of reproduction for use in connection with television."[239] A similar exemption from withholding for literary, dramatic, musical or artistic work is found in the Canada-U.S. Treaty, but the word "cultural" is omitted.[240]

In summary, the tax treaty between Canada and the United States provides for the most efficient exchanges of technology by reducing the withholding tax rate to zero with respect to certain classes of royalty payments. However, it is clearly the most complex of the three Royalty Articles to interpret and administer. The treaties between Canada and Mexico and the United States and Mexico are similar and impose similar withholding obligations on most royalty payments. One notable exception is with respect to certain cultural royalties which can flow freely between Canada and Mexico, but are subject to a withholding tax on transfers between the United States and its NAFTA treaty partners, Mexico and Canada.

2. *Article VII: Business Profits*

The Business Profits Article is an important tax treaty provision in establishing taxing jurisdictions. In general, business profits are not taxable in the host country unless the resident of the other treaty country carries on business, or has carried on business, in that country through a permanent establishment. If business is carried on through a permanent establishment in the host country, the business profits of the resident of the other country may be taxed only to the extent the profits are attributable to the permanent establishment.

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237 U.S.-Mex. Treas. Tech. Expl., *supra* note 176, Art. 12.

238 *Id.*

239 Mexico-Canada Treaty, *supra* note 120, Art. 12(3).

240 Canada-U.S. Treaty, 1995 Protocol, *supra* note 122, Art. XII(3)(a).

(a) Canada-U.S. Treaty

The Canada-U.S. Treaty provides that "the business profits of a resident of a Contracting State shall be taxable only in that State unless the resident carries on business in the other Contracting State through a permanent establishment situated therein."[241] Where a permanent establishment exists, business profits attributable to the permanent establishment include only those profits derived from the assets or activities of the permanent establishment,[242] calculated as if the permanent establishment were a distinct and separate entity engaged in the same or similar activities and dealing independently with its home office or any other related person.[243]

In determining the business profits of a permanent establishment, the Business Profits Article allows deductions for expenses incurred for purposes of the permanent establishment. Such expenses include executive and general administrative expenses incurred within or without the Contracting State in which the permanent establishment is located. However, a Contracting State is not required "to allow a deduction [for] any expenditure which, by reason of its nature, is not generally allowed as a deduction under the tax laws of that State."[244]

(b) U.S.-Mexico and Mexico-Canada Treaties

The Business Profits Articles of Mexico's tax treaties with both Canada and the United States are very similar to the Business Profits Article in the Canada-U.S. Treaty with two important variations, both of which relate to Mexico's developing country status. The first variation has the effect of

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[241] Can.-U.S. Treas. Tech. Expl., *supra* note 216, Art. VII. The "or has carried on" language of Article VII(1) makes it clear that the Contracting State in which the permanent establishment is situated has the right to tax business attributable to the permanent establishment, "even if there is a delay in the receipt or accrual of [income] until after the permanent establishment has been terminated." *Id.*

[242] Article VII(4) states that no profits will be attributed to the permanent establishment of a resident of a Contracting State merely by reason of the purchase of goods or provision of executive, managerial or administrative facilities or services. Canada-U.S. Treaty, *supra* note 122, Art. VII(4). Unless there is a good and sufficient reason to the contrary, the business profits attributable to a permanent establishment will be determined by the same method every year. *Id.* Art. VII(5). Article VII(7) clarifies that business profits attributable to a permanent establishment "are those [profits] derived from the assets or activities of the permanent establishment." *Id.* Art. VII(7). Nevertheless, Article VII(7) does not preclude Canada or the United States from using appropriate domestic tax law rules of attribution. The definition of "attributable to" means that "the limited 'force of attraction' rule of [I.R.C.] §864(c)(3) does not apply for U.S. tax purposes under the [Treaty]." Can.-U.S. Treas. Tech. Expl., *supra* note 216, Art. VII.

[243] For the purposes of Article VII(2), "related person" is defined under Article IX(2) as including either person if one person participates directly or indirectly in the management or control of the other or if any third person participates in the management or control of both. Canada-U.S. Treaty, *supra* note 122, Art. VII(2).

[244] *Id.* Art. VII(3).

a partial "force of attraction" by attributing to the permanent establishment home office sales.[245] Specifically, under the Canada-U.S. Treaty, the business profits of a resident of a Contracting State are taxable in the other State only if the resident carries on business through a permanent establishment situated in the other State and only to the extent the business profits are attributable to that permanent establishment.[246] In the two tax treaties with Mexico, the ability to tax is extended to sales in the other State of goods or merchandise of the same or similar kind as the goods or merchandise sold through the permanent establishment, unless it can be established that such goods or merchandise are not being sold for the purpose of obtaining a treaty benefit.[247]

The second variation is designed to prevent the attribution of excessive home office expenses to a permanent establishment. As with the Canada-U.S. Treaty, expenses incurred for purposes of the permanent establishment are deductible. Deductible expenses include executive and administrative expenses incurred within the State in which the permanent establishment is situated or elsewhere.[248] Mexico's treaties with Canada and the United States, however, specifically deny a deduction to a permanent establishment for payments, in excess of reimbursement for actual expenses, to the head office by way of royalties, commissions or similar payments in return for use of patents or other rights, or for specific services performed or for management, or, except for banks, by way of interest on funds lent to the permanent establishment.[249]

In a technology transfer agreement, the characterization of a payment is critical in determining its tax treatment. As seen, a payment to a business carried on through a permanent establishment in a host country is subject to tax by the host country while a royalty for the use of property may be subject to a withholding tax by the host country or tax exempt under the royalty provisions. However, if there is no permanent establishment in the host

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[245] U.S.-Mex. Treas. Tech. Expl., *supra* note 176, art 7. This provision derives from the U.N. Model and is frequently requested by developing countries to prevent avoidance of their tax. It is not found in the U.S. Model and does not represent preferred U.S. policy. *Id.*

[246] Canada-U.S. Treaty, *supra* note 122, Art. VII(1).

[247] Mexico-Canada Treaty, *supra* note 120, Art. 7(1); Canada-U.S. Treaty, *supra* note 122, Art. VII(1).

[248] U.S.-Mexico Treaty, *supra* note 121, Art. 7(3); Canada-U.S. Treaty, *supra* note 122, Art. VII(3); Mexico-Canada Treaty, *supra* note 120, Art. 7(3). Allocable expenses also include executive and general administrative expenses, research and development expenses, interest, and charges for management, consultancy, or technical assistance. The Protocol also clarifies that no deduction is allowed to the extent the expense has already been deducted by the enterprise or reflected in other deductions allowed to the permanent establishment such as the cost of goods sold or the value of purchases. U.S.-Mexico Treaty, 1992 Protocol, *supra* note 121, ¶5.

[249] U.S.-Mexico Treaty, *supra* note 121, Art. 7(3); Mexico-Canada Treaty, *supra* note 120, Art. 7(3). This exception reflects the U.N. Model and the Commentary to the OECD Model. U.S.-Mex. Treas. Tech. Expl., *supra* note 176, Art. 7.

country, payments in the form of business profits will always be exempt from host country taxation.

(c) Methods of Attributing Business Profits to Permanent Establishments

Since business profits become taxable in the source state only to the extent the business is carried on through a permanent establishment, it is important to determine the method by which business profits will be "attributable" to the permanent establishment.[250] Uncertainty about the method of attribution of income to a permanent establishment lead to a special OECD study and a report released in 1993 ("OECD Report").[251] In the study, the committee focused on transfers between a firm's head-office and its foreign permanent establishment and transfers between different permanent establishments of the same enterprise. According to the OECD Report, the uncertainty in the method of income attribution to a permanent establishment is heightened by the duality of approach suggested by Article 7 (Business Profits) of the OECD Model.[252] Although the preference in Article 7 is for attribution in accordance with the arm's length, separate accounts basis, the "indirect method" of allocation,[253] the Article permits the determination to be made on the basis of an apportionment of total profits of the enterprise, the "unitary method" of allocation, if such a method of allocation is customary in the signatory country and the result is in accordance with the principals contained in Article 7.[254] The OECD Model does require that the method employed in determining the profits to be attributed to a permanent establishment is consistent every year unless there is a good and sufficient reason to the contrary.[255]

The OECD Report states that the alternative methods approach allows tax authorities to, in some instances, treat a permanent establishment as an independent legal entity that will be evaluated according to the arm's length principal in being attributed a portion of the business profits and, in other instances, as a subdivision of the main enterprise, with the result that the transfer price will be valued by reference to historic cost.[256] Further, in applying the indirect method of allocation, Article 7(2) of the OECD Model

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[250] Canada-U.S. Treaty, *supra* note 122, Art. VII(1); U.S.-Mexico Treaty, *supra* note 121, Art. 7(1); Mexico-Canada Treaty, *supra* note 120, Art. 7(1).

[251] ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, REPORT ON ATTRIBUTION OF INCOME TO PERMANENT ESTABLISHMENTS, adopted by the Council of the OECD on November 26, 1993 [hereinafter OECD Report].

[252] *Id.* Part I(1).

[253] OECD Model, *supra* note 165, Art. 7(2)-(4). *See* 1992 OECD Commentary on Art. 7, *supra* note 195, ¶11-24 (discussing the "indirect method" of allocating business profits).

[254] OECD Model, *supra* note 165, Art. 7(4). *See* 1992 OECD Commentary on Art. 7, *supra* note 195, ¶25-28 (discussing the "unitary method" of allocating business profits).

[255] *Id.* Art. 7(6).

[256] OECD Report, *supra* note 251, Part I(2)(b).

requires that prices charged between the permanent establishment and head-office be charged on an arm's length basis while Article 7(3) requires that the deduction of expenses incurred for purposes of the permanent establishment be limited to the actual cost incurred and not include the profit element normally built into arm's length transactions. The OECD Report focuses on reconciling these directives which included addressing such specific issues as whether a particular cost is considered an expense incurred for purposes of the permanent establishment and whether a service is included as an element of profit to the provider.[257]

With regard to technology and trademarks, the OECD Report concludes that associate members of a group normally either share intangible costs or pay a royalty. Since ownership of an intangible right cannot be allocated to a distinct part of a single entity, royalties should not be charged; instead, it is more appropriate to allocate historic cost, and risk, between the various parts without any markup for profit.[258] Services may be charged at historic cost or cost plus markup. Most commonly, however, the providing of services is part of the general administrative expenses of the enterprise as a whole and should be allocated on the basis of historic cost to the various parts of the enterprise. However, where part of the trade consists of the provision of such services, cost plus profit markup should be charged.[259]

Revenue Canada, although generally in agreement with the position of the OECD, is of the view that the indirect method does not permit charging notional costs or a markup in costs.[260] In addition, payments such as interest and royalties or a commission on services provided by the head office will generally not be deductible.[261] The United States has taken a very strong view of the rules which should govern the allocation of income and the pricing of intangibles between related parties in its transfer pricing provisions. Specifically, the United States generally requires that the fair market value be paid on the transfer of, or the use of, all technology developed in the United States, and that fair market value be determined based on Internal Revenue Code §482 principles and related regulations defining

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[257] *Id.*

[258] *Id.* Part II(C.1)(b). These rules do not apply in allocating profits within a single entity. *Id.*

[259] *Id.* Part II(C.1)(c).

[260] *See* Cudd Pressure Control v. The Queen [1998] D.T.C. 6630 (disallowing the deduction of notional rent theoretically charged to the permanent establishment for use of two snubbing units in the Canadian off-shore).

[261] INCOME TAX TREATIES REFERENCE MANUAL, DAFCO COURSES 94 ITC 172 (2000). Revenue Canada's view is apparently based on *Twentieth Century Fox Film Corp. v. The Queen* where Justice Addy stated, ". . . the true nature of the relationship between the Canadian branch of the plaintiff cannot possibly involve a commission or a rental: a legal entity cannot rent or contract with itself." Twentieth Century Fox Film Corp. v. The Queen, D.T.C. 5513, 5520 (1985).

"arm's length."[262] The U.S. position conflicts with the Canadian view of the arm's length principle in this context, specifically with regard to whether a markup should be charged to a branch office.[263] Thus, it is unclear how the arm's length principle will be applied by Canada and the United States under the Canada-U.S. Treaty. However, it is clear that the differences in opinion between the two governments may lead to double taxation.

Mexico has also recently enacted transfer pricing rules with an avowed intent to conform these rules to the standards established by the OECD Model. Article 64-A of the Mexican Income Tax Code generally addresses inter-company services. The arm's length charge is considered to be the amount that would be charged for substantially similar services in an unrelated transaction. Under Mexican law, as under U.S. law, this approach can translate into adding a profit element over direct and indirect costs for rendering services. For this purpose, the Hacienda considers whether the service involves technical experience or know-how, and whether the price charged is commensurate with the benefit received. As can be expected, determining a subjective benefit can be difficult, as can reconciling the markup for intangibles with the revenue authorities of a not uninterested treaty partner.[264]

3. Article XIII: Capital Gains

Under the Capital Gains Article of the three tax treaties, generally, the right of a host country to tax gains from the alienation of property by a non-

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[262] "The purpose of I.R.C. § 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions." Treas. Reg. § 1.482-1(a)(1) (1999). In determining the taxable income of a controlled taxpayer, the standard is "that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." Treas. Reg. § 1.482-1(b) (1999). Since identical transactions rarely exist, the regulations provide specific methods to be used to evaluate whether transactions between or among members of the control group satisfy the arm's length standard and, if not, to determine the arm's length result. *See* Treas. Reg. §§ 1.482-2-1.482-6 (1999). In addition to interest, onerous penalties can apply in connection with an underpayment of tax arising from a transfer pricing adjustment. *See* I.R.C. § 6662(e). *See generally* BLESSING, *supra* note 167, ¶7.01[2][a] (discussing generally U.S. transfer pricing rules I.R.C. § 482).

[263] Canadian transfer pricing rules were introduced in 1997. *See* Income Tax Act, R.S.C., ch. 1, § 247 (1985) (Can.) [hereinafter I.T.A.].

[264] Transfer pricing provisions in Mexico are based on Articles 64, 64-A, 65 and 65-A of the Mexican Income Tax Law and regulations. *See* 2 TAX LAWS OF THE WORLD–MEXICO 65-67 (1999). In December 1996, major tax reform legislation was issued in the transfer pricing area, effective January 1, 1997. *Id.* Further amendments were made in both 1997 and 1998. *Id. See* Javier Labrador, et al., *Mexican Tax Law Amendments: Target Transfer Pricing and Tax Havens*, 8 J. INT'L TAX'N 82 (1997); Marc M. Levey & Gabriel Amante, *Gearing up Efforts for Increased Compliance, Mexican Transfer Pricing Regulations Track OECD Rules*, 8 J. INT'L TAX'N 450 (1997); Javier Labrador & Luis Comado, *1998 Mexican Tax Reform*, 9 J. INT'L TAX'N 30 (1998).

resident is limited to two circumstances: gains from the alienation of real property situated in that country,[265] and gains attributable to the alienation of personal property forming part of, or the alienation of, a permanent establishment or fixed base situated in that country.[266] The latter exception applies to a permanent establishment which the non-resident has or had in the host country and a fixed base which is or was available to a non-resident for the purpose of performing independent personal services.[267]

In general, the royalty provisions of the tax treaties referred to are limited to the use of intellectual and industrial property, and not its alienation.[268] Thus, the distinction between "use" and "alienation" has great importance since payments for the use of any property within the meaning of the term "royalties" are subject to a ten percent withholding tax in all three tax treaties,[269] while gain from the alienation of such property is exempt from tax unless the non-resident has a permanent establishment or fixed base in the host country.[270] Notwithstanding these important distinctions in potential tax treatment, the NAFTA tax treaties, like the OECD Model, do not define the term "alienation." According to the OECD Commentaries, the words "alienation of property" apply not only to "capital

[265] Canada-U.S. Treaty, *supra* note 122, Art. XIII(1); U.S.-Mexico Treaty, *supra* note 121, Art. 13(1); Mexico-Canada Treaty, *supra* note 120, Art. 13(1). *See* Canada-U.S. Treaty, *supra* note 122, Arts. VI(2), XIII(3)(c) (defining the term "real property"); U.S.-Mexico Treaty, *supra* note 121, Arts. 6(2), 13(2)(a) (defining the term "immovable property"); Mexico-Canada Treaty, *supra* note 120, Arts. 6(2), 13(4) (defining the term "immovable property").

[266] Canada-U.S. Treaty, *supra* note 122, Art. XIII(2); U.S.-Mexico Treaty, *supra* note 121, Art. 13(3); Mexico-Canada Treaty, *supra* note 120, Art. 13(2).

[267] Canada-U.S. Treaty, *supra* note 122, Art. XIII(2); U.S.-Mexico Treaty, *supra* note 121, Art. 13(2); Mexico-Canada Treaty, *supra* note 120, Art. 13(2). The ability of the host country to tax the gains from the alienation of a permanent establishment which the non-resident had in the host country, or a fixed base which was available to the non-resident in the host country, is limited to a period of 12 months preceding the date of alienation by the Canada-U.S. Treaty. Canada-U.S. Treaty, *supra* note 122, Art. XIII(2). *See infra* Part IVB5 (discussing the treaty treatment of independent personal services and the distinction between permanent establishment and fixed base).

[268] The exception to this general rule is gain derived from the alienation of any right or property within the meaning of the term "royalties", if such gain is contingent on the productivity, use or disposition of the right or property. Canada-U.S. Treaty, *supra* note 122, Art. XII(4); U.S.-Mexico Treaty, *supra* note 121, Art. 12(3); Mexico-Canada Treaty, *supra* note 120, Art. 12(4).

[269] Canada-U.S. Treaty, *supra* note 122, Art. XII(2); U.S.-Mexico Treaty, *supra* note 121, Art. 12(2); Mexico-Canada Treaty, *supra* note 120, Art. 12(2); Mexico-Canada Treaty, 1991 Protocol, *supra* note 120. The Canada-U.S. Treaty and the Mexico-Canada Treaty provide an exemption from withholding for certain royalty payments. Canada-U.S. Treaty, *supra* note 122, Art. XII(3); Mexico-Canada Treaty, *supra* note 120, Art. 12(3). *See infra* text accompanying note 270 (discussing the exemption from the withholding tax for certain royalty payments).

[270] Canada-U.S. Treaty, *supra* note 122, Art. XIII(4). U.S.-Mexico Treaty, *supra* note 121, Arts. 13(6)-(7); Mexico-Canada Treaty, *supra* note 120, Art. 13(6).

gains" from the sale or exchange of property, but also to a partial alienation, expropriation, transfer to a company in exchange for stock, the sale of a right in property, and the gifting or testamentary passing of property on death.[271] Thus, the OECD Model does not limit the term "alienation" to include only the types of dispositions that produce "capital gains."[272]

Under each of the tax treaties, if a term is not given a specific definition, the domestic law of the country applying the treaty will provide the meaning of the term.[273] Therefore, in order to determine whether an alienation has occurred for treaty purposes, the parties must first determine which country's tax laws apply to a particular transaction. In some cases, arguably, both signatory countries may have grounds to assess a tax liability on the same transaction. For example, assuming a permanent establishment does not exist in the non-resident country, if under the domestic tax laws of a country the consideration received by a non-resident within that country is considered a royalty payment, and under the domestic tax laws of the resident country the consideration is viewed as gain from the alienation of property, double taxation will occur. The non-resident country will withhold tax while the resident country will tax the gain on the alienation and not credit the withholding tax paid to the non-resident country.

Further, even if the domestic tax law of a country clearly applies, the domestic law of that country may not be clear as to the distinction between "use" and "alienation." Under the domestic laws of the United States[274] and

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[271] 1992 OECD Commentary on Art. 13, *supra* note 195, ¶5.

[272] Under U.S. tax law, generally, gain from the alienation of property is included in gross income and taxed according to a progressive rate schedule. *See* I.R.C. § 61(a)(3). However, gain from the sale or exchange of a capital asset as defined in I.R.C. § 1221 or property described in I.R.C. § 1231(b) is taxed at preferential rates. *See* I.R.C. § 1(h). Under U.S. tax law, the only type of alienation which results in capital treatment is an actual or deemed "sale or exchange" of the property. *See* I.R.C. § 1222(3). In Canada, any alienation results in a capital gain, although in some cases the amount may be taxed as ordinary income if the taxpayer is involved in an adventure or concern in the nature of a business, or is selling an asset that is considered to be inventory. *See* I.T.A. § 248(1) (defining "business"); *see also* I.T.A. § 54 (defining "capital property"). Mexican taxpayers are taxed on gains derived from the disposition of real and personal property. Normally, capital gains on the sale or exchange of capital assets are taxed as ordinary income at regular rates. However, the tax basis used in determining the amount of gain or loss on a disposition of property is adjusted for inflation. *See* 1998 INTERNATIONAL TAX SUMMARIES: A GUIDE FOR PLANNING AND DECISIONS, COOPERS & LYBRAND GLOBAL TAX NETWORK M-55, M-58 (1998) (on file with the Northwestern Journal of International Law & Business).

[273] Canada-U.S. Treaty, *supra* note 122, Art. III(2); U.S.-Mexico Treaty, *supra* note 121, Art. 3(2); Mexico-Canada Treaty, *supra* note 120, Art. 3(2). The U.S. Treasury Department Technical Explanation of the Canada-U.S. Treaty provides that the term "alienation" means the sale, exchanges, and other dispositions or deemed dispositions that are taxable events under the tax law of the Contracting State applying the provisions of the Article. Can.-U.S. Treas. Tech. Expl., *supra* note 216, Art. XIII.

[274] Under U.S. tax law, gross income includes gains derived from dealings in property. *See* I.R.C. § 61(a)(3). Unless otherwise provided, all gain or loss realized on the disposition

Canada,[275] great uncertainty exists as to when an alienation occurs with respect to intellectual property, particularly transfers of patents and know-how.[276] Mexican law is also uncertain, providing only that alienation of property constitutes a taxable event and includes any transfer of property even though the transferor retains the control of the transferred property.[277]

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of property will be recognized. *See* I.R.C. § 1001(c). Generally, a copyright for a literary, musical, artistic composition, or similar property held by the creator is a non-capital asset and, therefore, is subject to ordinary income treatment on a disposition. *See* I.R.C. § 1221(a)(3). Certain types of intellectual property, however, receive special treatment under specific code sections: patents, I.R.C. § 1235, and franchises, trademarks, and trade names, I.R.C. § 1253. The question of whether a disposition has completely terminated a taxpayer's interest in property for tax purposes has generated a tremendous amount of complexity in the tax law. The answer controls many aspects of tax liability including the amount of any gain, the timing of the inclusions of any gain, and character of, and ultimately the rate of tax applied to, any gain. *See* Comm'r v. P.G. Lake, Inc., 356 U.S. 260 (1958). Under I.R.C. § 1235, a holder of a patent need only transfer "all substantial rights" to a patent in order to receive preferential capital treatment, regardless of whether the payments received are payable periodically over a period coterminous with the transferee's use of the patent or are contingent on productivity, use or disposition of the property. The "holder of the patent" is either the individual who created the patent or any other individual who acquired an interest in the patent property for consideration from the original inventor prior to the actual practice of the invention covered by the patent. I.R.C. § 1235(b). With regards to franchises, trademarks and trade names, special rules are provided under I.R.C. § 1253 to determine whether a transfer constitutes a sale or exchange or a license agreement. Generally, to receive capital treatment, a transferor cannot retain "any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name." I.R.C. § 1253(a).

[275] Canadian case law relies heavily on United Kingdom jurisprudence in determining whether the transfer of a patent results in a disposition which is eligible for capital treatment. Generally, the matter is determined as a question of fact. In summary, the rights transferred must injuriously affect the property. The transferor may retain the right to exploit the patent in a country other than the transferee's without compromising capital treatment. However, the transferor may not: (1) impose restrictions on the purpose for which a patent may be used; or (2) limit the time during which the patent may be exploited to a period that is less than its useful life. *See, e.g.*, Murray v. ICI Ltd., 2 All E.R. 980 (C.A. 1967); Commissioners of Inland Revenue v. British Salmson Aero Ltd., 22 T.C. 29 (1938); Nethersole v. Withers, HM Inspector of Taxes, 28 T.C. 501 (C.A. 1946). Under Canadian law, even where an outright sale or grant of an exclusive license is established, capital gains treatment will be denied if the sale or license constitutes "an adventure or concern in the nature of trade." I.T.A. § 248. Proceeds from the sale or assignment of an exclusive license for a patent may qualify for capital gains treatment under Canadian law if payment is not dependant on use of the patent. *See* No. 486 v. MNR [1958] D.T.C. 67; No. 487 v. MNR [1958] D.T.C. 68; No. 442 v. MNR [1957] D.T.C. 435. *See* I.T.A. § 12(1)(g). In contrast, the assignment of a non-exclusive license to use a patent will not qualify for capital gains treatment. *See* Canadian Industries Ltd. v. The Queen, [1977] C.T.C. 172, *aff'd* [1980] C.T.C. 222.

[276] A guaranteed minimum payment is not considered a royalty in this context. Can.-U.S. Treas. Tech. Explanation, *supra* note 216, Art. XII.

[277] Ley del Impuesto sobre la Renta, Arts. 132-135(a), *reprinted in* 2 TAX LAWS OF THE WORLD–MEXICO 126 (1999). Generally, payments received with regard to intellectual property, whether as a result of an alienation or use, are included in income and taxed at regular rates. *See generally* 2 JORGE A. VARGAS, MEXICAN LAW: A TREATISE FOR LEGAL PRACTIONERS AND INTERNATIONAL INVESTORS (1998) (explaining the Mexican law system).

The bilateral tax treaties among the NAFTA signatories provide that the matter of undefined terms may be resolved by mutual agreement.[278] This is the appropriate forum for determining which country's tax laws apply to a transaction and ultimately whether an alienation has occurred.[279]

4. Article V: Permanent Establishment

The permanent establishment provisions provide a complete exemption from, or impose limits on, the host country's right to tax temporary, preliminary, or exploratory activities.[280] The tax treaties of the NAFTA signatories require the existence of a permanent establishment before imposing tax on non-resident activities and then limit the tax imposed to income directly attributable to the permanent establishment. Once a permanent establishment or fixed base exists in the host country, tax liability will extend to any business profits,[281] independent personal services,[282] and gains from the alienation of personal property[283] attributable to the permanent establishment or fixed base.[284] If the non-resident taxpayer's intent is to avoid tax liability, a clear understanding of the permanent establishment rules and meticulous attention to the details of the technology transfer arrangement is required. This is particularly true in the NAFTA block, since the tax treaties vary significantly among the three NAFTA partners with respect to the definition of a permanent establishment.

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278 Canada-U.S. Treaty, *supra* note 122, Art. III(2); U.S.-Mexico Treaty, *supra* note 121, Art. 3(2); Mexico-Canada, *supra* note 120, Art. 3(2).

279 Canada-U.S. Treaty, *supra* note 122, Art. XXVI(3); U.S.-Mexico Treaty, *supra* note 121, Art. 26(3); Mexico-Canada Treaty, *supra* note 120, Art. 24(4).

280 BAKER, *supra* note 177, at 140.

281 Canada-U.S. Treaty, *supra* note 122, Art. VII(1); U.S.-Mexico Treaty, *supra* note 121, Art. 7(1); Mexico-Canada Treaty, *supra* note 120, Art. 7(1).

282 Canada-U.S. Treaty, *supra* note 122, Art. XIV; U.S.-Mexico Treaty, *supra* note 121, Art. 14(1); Mexico-Canada Treaty, *supra* note 120, Art.14(1).

283 Canada-U.S. Treaty, *supra* note 122, Art. XIII(2); U.S.-Mexico Treaty, *supra* note 121, Art. 13(3); Mexico-Canada Treaty, *supra* note 120, Art. 13(2).

284 The term "permanent establishment" is also relevant to the application of the Mexican assets tax. The assets tax will not apply to U.S. residents who are not subject to tax under Article 5 (Business Profits) or Article 7 (Permanent Establishment). The exceptions are assets referred to in Article 6(2) (Immovable Property) and Article 12(3) (Royalties) that are furnished to residents of Mexico. In the case of the former, generally, Mexico will grant a credit against tax on such assets in an amount equal to the Mexican income tax imposed on the gross income derived from such property. In the latter case, Mexico will "grant a credit against the tax on such assets in an amount equal to the income tax that would have been imposed on the royalties paid . . . applying the rate of tax provided [under] Mexican Income Tax Law instead of the [lower] rate provided in Article 12." U.S.-Mexico Treaty, 1992 Protocol, *supra* note 121, ¶3. The resulting credit, generally 21% of the gross income, is expected to eliminate any asset tax liability. If no royalty is paid, then an asset tax liability will result because there will be no income from the property to produce a credit. *See* U.S.-Mexico Treaty, 1992 Protocol, *supra* note 121, ¶ 3.

(a) Canada-U.S. Treaty

The Canada-U.S. Treaty defines a "permanent establishment" as "a fixed place of business through which the business of a resident of a Contracting State is wholly or partly carried on."[285] The term includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.[286] In addition, a building site or construction or installation project that continues for a period of more than twelve months is considered a permanent establishment.[287] Finally, the use of a drilling rig or ship in the other Contracting State for a period of more than three months in any twelve-month period to explore for or exploit natural resources will fall within the definition.[288]

The term "permanent establishment" does not include a fixed place of business used solely for, or a person[289] engaged in, one or more[290] of specified activities: the use of facilities for the purpose of storage, display or delivery of goods belonging to the resident whose business is carried on; the maintenance of a stock of goods belonging to the resident for the purpose of storage, display or delivery; the maintenance of a stock of goods belonging to the resident for the purpose of processing by another person; the purchase of goods, or the collection of information, for the resident; and advertising, the supply of information, scientific research or similar activities which have a preparatory or auxiliary character.[291] The reference in the final exception to specific activities does not imply that activities of a preparatory or auxiliary character with regard to other activities, "for example, the servicing of a patent or a know-how contract," do not fall within this exception.[292]

Although the definition of what constitutes a permanent establishment appears straightforward, its application in the context of technology transfer arrangements is not. For example, according to the OECD Commentary, a "place of business" may include any premises used in business, whether or not exclusively used for that purpose, and a place of business may exist

[285] Canada-U.S. Treaty, *supra* note 122, Art.V(1).

[286] *Id.* Art. V(2).

[287] *Id.* Art. V(3).

[288] *Id.* Art. V(4).

[289] The term "person" is defined as "[a] person acting in a Contracting State on behalf of [a non-resident]...[who] has, and habitually exercises...an authority to conclude contracts in the name of the [non-]resident." *Id.* Art. V(5).

[290] Unlike the OECD Model Treaty, a combination of the specified activities has the same status as any one of the activities. *See* Can.-U.S. Treas. Tech. Expl., supra note 216, Art. V; M. G. Quigley, *Permanent Establishment Under the Canada-United States Tax Treaties — The Old and the New*, N.C. J. INT'L L. & COM. REG. 363 (1982) (discussing "permanent establishment" under the Canada-United States Tax Treaties).

[291] Canada-U.S. Treaty, *supra* note 122, Art. V(6).

[292] Can.-U.S. Treas. Tech. Expl., *supra* note 216, art V.

where space is merely held at the non-residents' disposal by another business enterprise.[293] The OECD Commentary also provides that where tangible property such as facilities, industrial, commercial or scientific equipment, or intangible property such as patents or procedures, is let or leased to third parties through a fixed place of business in the other country, this activity will, in general, render the place of business a permanent establishment. In contrast, if there is no fixed place of business in the host country, these activities would not normally constitute a permanent establishment, even where the lessor provides personnel after installation to operate the equipment, provided that their responsibility is limited solely to the operation or maintenance of the equipment under the direction, responsibility and control of the lessee.[294]

Another circumstance under which a permanent establishment may be found is where a non-resident has a person acting in the source country on its behalf, if such person has, and habitually exercises, the authority to conclude contracts in the name of the non-resident.[295] A non-resident will not

[293] 1992 OECD Commentary on Art. V(1), *supra* note 195, ¶5(4). In applying this provision, the Canada Customs and Revenue Authority has stated that a permanent establishment may exist where a Canadian subsidiary makes space available to a foreign corporation, for example, to provide management services to its subsidiary for a fee. Technical Interpretation 9409325 – "Permanent Establishment," (July 27, 1994) (on file with author). The United States, in contrast, appears to have adopted a more generous view towards the use by non-resident employees of business space situated in the United States. In Revenue Ruling 77-45, the Internal Revenue Service found that a Canadian corporation that performed engineering services in the United States in connection with a project that lasted less than one year did not have a permanent establishment. Although the ruling emphasized that the on-site employees worked in a construction shed supplied by the client and that its use was without separately bargained for consideration, the end result was that a permanent establishment was not found. *See* Rev. Rul. 77-45, 1977-1 C.B. 413; BLESSING, *supra* note 167, ¶3.02[1][b][i] (providing a discussion on the "place of business" within the definition of "permanent establishment").

[294] 1992 OECD Commentary on Art. 5(1), *supra* note 195, ¶8; BLESSING, *supra* note 167, ¶ 3.02[1][b][iii] (elaborating on the language "carrying on a business" as within the definition of "permanent establishment").

[295] Canada-U.S. Treaty, *supra* note 122, Art. V(5). *See* J.F. Avery Jones & D.A. Ward, *Agents as Permanent Establishments under the OECD Model Tax Convention*, BRITISH TAX REV. 341 (1993) (analyzing agents as permanent establishments under the OECD Model); E. W. Madole, *Agents as Permanent Establishments Under U.S. Income Tax Treaties*, 23 TAX MGMT. INT'L J. 281 (1994) (discussing agents as permanent establishments under the U.S. Income Tax Treaties). The Internal Revenue service has been particularly aggressive in interpreting when an agent constitutes a permanent establishment. In *Taisei Fire and Marine Insurance Co., Ltd. v. Comm'r*, for example, the Internal Revenue Service alleged that four Japanese property and casualty insurance companies were a U.S. permanent establishment by virtue of the activities of a U.S. agent in accepting reinsurance on their behalf. This would have resulted in U.S. tax liability for the Japanese insurers on the basis of the profits attributable to the U.S. permanent establishment. The U.S. Tax Court held that no agency relationship existed as the agent was both independent and acting in the ordinary course of business. *See* Taisei Fire and Marine Insurance Co., Ltd. v. Comm'r, 104 T.C. 535 (1995),

be deemed to have a permanent establishment merely because the non-resident carries on business in the non-resident country "through a broker, general commission agent or any other agent of an independent status, provided that such [person is] acting in the ordinary course of business."[296] The mere fact that a non-resident controls or is controlled by a company which is a resident of the source country, or carries on business in the source country, whether or not through a permanent establishment, will not, in and of itself, result in either company being a permanent establishment.[297]

The precise scope of the exceptions to the permanent establishment provision will be difficult to determine in a technology transfer context. For example, a fixed place of business maintained by an enterprise to supply spare parts to its customers in respect of machinery or equipment sold by the enterprise, or to maintain or repair such machinery, may not fall within the exceptions as mere auxiliary activities. The supply of information through a fixed place of business can fall within or outside the exception depending on how closely the information is tailored to meet the needs of a particular client.[298]

(b) U.S.-Mexico and Mexico-Canada Treaties

The definition of "permanent establishment" in the U.S.-Mexico[299] and Mexico-Canada[300] Treaties are, generally, the same as the definition found in the Canada-U.S. Treaty.[301] One notable exception is that the period required to establish a permanent establishment in the case of a building, construction or assembly site is shortened from twelve months to six months in the tax treaties with Mexico.[302] This is consistent with the U.N. Model and in keeping with Mexico's developing country status. The result, however, is that construction, assembly or other similar projects must be limited to six months or less if Mexican tax is to be avoided.[303] In the U.S.-Mexico Treaty, a special rule was also added to treat *maquiladora* operations as permanent establishments.[304]

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acq., action on decision 1995-012 (1995); BLESSING, *supra* note 167, ¶ 3.02[3][b][iii] (discussing agency as a treaty concept).

[296] Canada-U.S. Treaty, *supra* note 122, Art.V(7).

[297] *Id.* Art. V(8).

[298] 1992 OECD Commentary on Art. V(4), *supra* note 195, ¶25.

[299] U.S.-Mexico Treaty, *supra* note 121, Art. 5(1).

[300] Mexico-Canada Treaty, *supra* note 120, Art. 5(1).

[301] Canada-U.S. Treaty, *supra* note 122, Art. V(1).

[302] *Id.* art V(3); U.S.-Mexico Treaty, *supra* note 121, Art. 5(3); Mexico-Canada, *supra* note 120, Art. 5(3).

[303] U.S.-Mex. Treas. Tech. Expl., *supra* note 176, Art. 5.

[304] U.S.-Mexico Treaty, *supra* note 121, Art. 5(5)(b). The U.S.-Mexico Treaty allows the Mexican government to treat *maquiladoras* as permanent establishments. *Maquiladora* op-

The definition of a "permanent establishment" excludes a similar list of activities as those excluded under the Canada-U.S. Treaty.[305] Nevertheless, Mexico's treaties with both the United States and Canada contain an additional exclusion for a fixed place of business solely for the purpose of preparations relating to the placement of loans.[306] Further, a provision clarifies that the maintenance of a fixed place of business solely for any combination of otherwise excluded activities, will also be excluded, provided that the total activity of the combination remains of a preparatory or auxiliary character.[307]

The Canadian and United States treaties with Mexico also contain similar provisions as to when an agent will constitute a permanent establishment. Where a person, other than an independent agent,[308] is acting in the source country on behalf of an enterprise of the other country, that enterprise will be deemed to be a permanent establishment in respect to any activities which that person undertakes for the enterprise, if such person

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erations frequently involve importing technology, components, and equipment from a U.S. company, assembling the components under the supervision of U.S. management personnel, and shipping the finished products to the U.S. company under a cost-plus arrangement. As a matter of administrative practice, Mexico did not treat a *maquiladora* operation as a Mexican permanent establishment of the U.S. principal. More recently, the Mexican authorities began changing their position with respect to the *maquiladora.* Decree for the Encouragement and Operation of the Maquiladora (In-Bond) Export Industry, Arts. 1-27. *See* Alan S. Lederman and Bobbe Hirsh, *U.S.-Mexico Tax Treaty Complements NAFTA*, 79 J. TAX'N 100, 103 (1993). After much negotiation, in October 1999, the U.S. and Mexican Competent Authorities agreed on a tax regime for *maquiladoras* that will apply from 2000 through 2002. Generally, notwithstanding the provisions of Article 5 of the U.S.-Mexico Treaty, a U.S. parent company with *maquiladora* operations in Mexico will not be deemed to have a permanent establishment in Mexico, provided it complies with either of two requirements: (1) the *maquila* enterprise reports taxable income that is the higher of 6.9 percent of the value of the assets owned by the U.S. parent and the *maquiladora,* or 6.5 percent of the deductions for costs and expenses of the *maquila* enterprise, or (2) the *maquiladora* obtains a ruling to the effect that it complies with Mexico's transfer pricing provisions. *See* I.R.S. News Release IR-INT-1999-13 (Oct. 29, 1999); *Agreement Reached on Tax Regime for Maquiladoras by Competent Authorities,* 210 DAILY TAX REP. G-6 (Nov. 1, 1999).

[305] Canada-U.S. Treaty, *supra* note 122, Art. V(6); U.S.-Mexico Treaty, *supra* note 121, Art. 5(4); Mexico-Canada Treaty, *supra* note 120, Art. 5(4).

[306] U.S.-Mexico Treaty, *supra* note 121, Art. 5(4)(e); Mexico-Canada Treaty, *supra* note 120, Art. 5(4)(e). Since an office used for the preparation relating to the placement of loans is not deemed a permanent establishment, the income generated will not be subject to tax by Mexico under Article 7 (Business Profits); rather, the interest earned by the U.S. banks will be subject to the provisions of Article 11 (Interest). *See* U.S.-Mex. Treas. Tech. Expl., *supra* note 176, Art. 5.

[307] U.S.-Mexico Treaty, *supra* note 121, Art. 5(4)(f); Mexico-Canada Treaty, *supra* note 120, Art. 5(4)(f). *See* Barry Michael Cass & Richard E. Andersen, *U.S.-Mexico Treaty Combines Developed and Developing Country Models*, 3 J. INT'L TAX'N 197 (1992).

[308] *See* U.S.-Mexico Treaty, *supra* note 121, Art. 14 (defining independent personal services); Mexico-Canada Treaty, *supra* note 120, Art. 14 (defining independent personal services).

has, and habitually exercises, an authority to conclude contracts in the name of such enterprise, unless the activities are otherwise excluded from the definition of a permanent establishment.[309] Further, if an independent agent is hired in the host country, an enterprise will not be deemed a permanent establishment merely because it carries on business through a broker, general commission agent, or other agent of independent status, provided such person is acting in the ordinary course of business.[310]

5. *Article XIV: Independent Personal Services*

In general, compensation for personal services performed by a self-employed individual in the non-resident country is taxed in that country, if the individual has or had a fixed base in the non-resident country, but only to the extent the compensation is attributable to the fixed base. Thus, income from independent personal services is treated similarly to business profits under Article VII (Business Profits).[311]

The Canada-U.S. Treaty provides as follows:

> Income derived by an individual who is a resident of a Contracting State in respect of independent personal services may be taxed in that State. Such income may also be taxed in the other Contracting State if the individual has or had a fixed base regularly available to him in that other State but only to the extent that the income is attributable to the fixed base.[312]

The Independent Personal Services Articles of the U.S.-Mexico Treaty[313] and the Mexico-Canada Treaty[314] contain language similar to the Canada-U.S. Treaty.[315] Nevertheless, the two tax treaties with Mexico pro-

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[309] U.S.-Mexico Treaty, *supra* note 121, Art. 5(5)(a); Mexico-Canada Treaty, *supra* note 120, Art. 5(5).

[310] U.S.-Mexico Treaty, *supra* note 121, Art. 5(7); Mexico-Canada Treaty, *supra* note 120, Art. 5(7). This exception is limited in the tax treaty between Mexico and Canada. If the activities of an agent are exercised wholly or almost wholly on behalf of a treaty taxpayer, the agent will not be considered an agent of independent status for purposes of claiming the exemption. Such an agent would, therefore, create tax liability for the enterprise in Mexico. Mexico-Canada Treaty, *supra* note 120, Art. 5(7).

[311] *See* Canada-U.S. Treaty, *supra* note 122, Part IV.B.2 (discussing the tax treatment of business profits).

[312] *See id.* Art. XIV. The use of the language "has or had" ensures that the source state "has [a] right to tax income attributable to [a] fixed base even if there is a delay between the termination of the fixed base and the receipt or accrual of such income." Can.-U.S. Treas. Tech. Expl., *supra* note 216, Art. XIV.

[313] U.S.-Mexico Treaty, *supra* note 121, Art. 14(1)(a).

[314] Mexico-Canada Treaty, *supra* note 120, Art. 14(1).

[315] Canada-U.S. Treaty, *supra* note 122, Art. XIV. Generally, notwithstanding Article VII (Business Profits), Article XIV (Independent Personal Services), and Article XV (Dependent Personal Services), the income derived from personal services as a performer or athlete in the non-resident country may be taxed in that country. *See id.*; U.S.-Mexico Treaty, *supra* note 121, Art. 18; Mexico-Canada Treaty, *supra* note 120, Art. 17. Point 14 of the contemporaneous Protocol to the U.S.-Mexico Treaty extends Article 14 to income derived by a resident U.S. company furnishing personal service through a fixed base in Mex-

vide an exemption from tax at the source on income from independent personal services. Specifically, a non-resident may avoid source country taxation despite a fixed base in the source country if the individual is not present in that country for a period or periods aggregating 183 days or more in a twelve-month period.[316] Canadian and U.S. treaties with Mexico also define the term "personal services" to include "especially independent scientific, literary or artistic activities, educational or teaching activities, as well as independent activities of physicians, lawyers, engineers, architects, dentists and accountants."[317]

Important to the application of the Independent Personal Services Articles is the definition of the "fixed base." Unlike the term "permanent establishment,"[318] "fixed base" is not defined in any of the three treaties under discussion or in the OECD Model.[319] Paragraph 4 of the OECD Commentary on Article 14 states that even though Article 7 (Business Profits) and Article 14 (Independent Personal Services) are based on the same principals, the concept of permanent establishment should be reserved for commercial and industrial activities, therefore, the term "fixed base" is used. Although not "thought appropriate to try to define it," the term includes, for instance, "a physician's consulting room or the office of an architect or a lawyer." Usually, an individual performing independent personal services would have premises of this type only in a state of residence; however, if

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ico. 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." U.S.-Mexico Treaty, 1992 Protocol, *supra* note 121, ¶14. "In the converse case, the United States will apply Article 7 (Business Profits) directly." U.S.-Mex. Treas. Tech. Expl., *supra* note 176, Art. 14. As such, under Mexican law, a personal service company does not earn business profits and such income must be taxed under Article 14. *Id.*

[316] U.S.-Mexico Treaty, *supra* note 121, Art. 14(1)(b); Mexico-Canada Treaty, *supra* note 120, Art. 14(1). When services are performed partly in Mexico, the non-resident taxpayer has the burden of proving that part of the services were performed outside of Mexico. In accordance with the principles of Article 7 (Business Profits), the tax base is net of expenses incurred in earning the income. U.S.-Mex. Treas. Tech. Expl., *supra* note 176, Art. 14.

[317] U.S.-Mexico Treaty, *supra* note 121, Art. 14(2); Mexico-Canada Treaty, *supra* note 120, Art. 14(2). The term "independent personal services" is primarily concerned with professional services. The list was derived from the OECD Model and is not exhaustive. "The term includes all personal services performed by an individual for [the individual's] own account where [the individual] receives the income and bears the risk of loss." U.S.-Mex. Treas. Tech. Expl., *supra* note 176, Art.14. *See infra* note 319 (providing the OECD Model definition of "professional services").

[318] *See supra* text accompanying note 285 (defining the term "permanent establishment").

[319] The OECD Model provides that income derived by a non-resident individual for professional services or other activities of an independent nature is taxable by the non-resident country only if, and to the extent attributable to, a fixed base is regularly available to the individual in the non-resident state. *See* OECD Model, *supra* note 165, Art. 14(1). "Professional services" are defined to include "especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants." *Id.* Art. 14(2).

another state is "a centre of activity of a fixed or a permanent character," then the other state may tax the income from the person's activities.[320]

6. *Article XV: Dependent Personal Services*

The transfer of technology may also involve the transfer of services provided by the transferor's employees. With regard to this scenario, two issues arise: first, the liability of the non-resident employee for tax in the source country for services performed in the source country and, second, the tax treatment of payments made to the non-resident transferor for employee services performed in the source country. Generally, under all three tax treaties, compensation for services derived in respect of employment is taxable only by the resident country of the individual providing the services, unless the employment is exercised in the non-resident country.[321]

Even though the employment is exercised in the source country, the right to tax remains with the country of residence if the employee is present in the source country for a period or periods not exceeding in the aggregate 183 days in a twelve-month period;[322] the remuneration is paid by, or on behalf of, an employer who is not a resident of the source country; and is not borne by[323] a permanent establishment or a fixed base that the employer has in the source country.[324] The Mexico-Canada[325] and the Canada-U.S.[326] Treaties provide an additional exemption for employees whose remuneration does not exceed 1,500 Canadian dollars, or its equivalent in Mexican pesos, or 10,000 dollars in the source country's currency, respectively.

The tax treatment of amounts paid to the transferor in respect of services performed by its employees in the source country will depend on whether the transferor carries on business in the source country through a permanent establishment situated in the source country. If so, income generated for providing employee services is taxed by the source country under

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[320] 1992 OECD Commentary on Art. 14, *supra* note 195, ¶4. The concept of "fixed base" differs from the concept of "permanent establishment" in two respects: "(1) the degree of permanency . . . is less stringent, and (2) the place from which the liberal profession is performed does not need to be especially equipped for the performance of the activity." BAKER, *supra* note 177, at 296.

[321] Canada-U.S. Treaty, *supra* note 122, Art. XV(1); U.S.-Mexico Treaty, *supra* note 121, Art. 15(1); Mexico-Canada Treaty, *supra* note 120, Art. 15(1).

[322] In the calculation of the 183-day period, the OECD Commentary provides that any day of physical presence in the host country, including days of departure and arrival, sick days, and holidays, should be included in the computation. 1992 OECD Commentary on Art. 15(2), *supra* note 195, ¶5.

[323] The term "borne by" means allowable as a deduction in computing taxable income. Can.-U.S. Treas. Tech. Expl., *supra* note 216, Art. XV.

[324] Canada-U.S. Treaty, *supra* note 122, Art. XV(2)(b); U.S.-Mexico Treaty, *supra* note 121, Art. 15(2); Mexico-Canada Treaty, *supra* note 120, Art. 15(2)(b).

[325] Mexico-Canada Treaty, *supra* note 120, Art. 15(2)(a).

[326] Canada-U.S. Treaty, *supra* note 122, Art. XV(2)(a).

Article VII (Business Profits). Further, technical service fees may be royalties for the purposes of Article XII in cases where the fees are periodic and dependent on productivity or a similar measure, or ancillary to the transaction giving rise to the royalty payment.[327] Finally, services ancillary to the disposition of property may be governed by Article XIII (Capital Gains) and, therefore, not subject to source country tax, if the property does not form part of a permanent establishment or fixed base in the source country.

7. *Article IX: Associated Enterprises*

The Associated Enterprises provision "encapsulates the arm's length principle that generally is accepted as the international norm by which tax administrators resolve cross-border disputes."[328] In general, where the residents of two Contracting States are related parties and where the arrangements between them are not at arm's length, the Contracting States may make appropriate adjustments to the amount of income, loss or tax payable of the parties in order to reflect the income, deductions, credits or allowances that each would have had if the transaction between them had been at arm's length.[329] The parties are deemed related if either person participates directly or indirectly in the management or control of the other, or a third person (or persons) participates directly or indirectly in the management or control of both.[330] The term "control" includes any kind of control, whether or not legally enforceable and however exercised or excisable.[331] If an adjustment is made by a Contracting State, the other Contracting State must make a corresponding adjustment, provided the other State agrees with the adjustment.[332]

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[327] Can.-U.S. Treas. Tech. Expl., *supra* note 216, Art. XII.

[328] BLESSING, *supra* note 167, at ¶ 7.01[1].

[329] Canada-U.S. Treaty, *supra* note 122, Art. IX(1); U.S.-Mexico Treaty, *supra* note 121, Art. 9(1)-(2); Mexico-Canada Treaty, *supra* note 120, Art. 9(1)-(2); U.S.-Mex. Treas. Tech. Expl., *supra* note 176, Art. 9. The tax treaties with Mexico refer only to the reallocation of profits and income. *See* U.S.-Mexico Treaty, *supra* note 121, Art. 9(1); Mexico-Canada, *supra* note 120, Art. 9(1)-(2).

[330] Canada-U.S. Treaty, *supra* note 122, Art. IX(2); U.S.-Mexico Treaty, *supra* note 121, Art. (9)(1); Mexico-Canada Treaty, *supra* note 120, Art. 9(1). The tax treaties with Mexico add participation in capital as a factor creating a relationship. U.S.-Mexico Treaty, *supra* note 121, Art. 9(1); Mexico-Canada Treaty, *supra* note 120, Art. 9(1).

[331] U.S.-Mex. Treas. Tech. Expl., *supra* note 176, Art. 9.

[332] Canada-U.S. Treaty, *supra* note 122, Art. IX(3); U.S.-Mexico Treaty, *supra* note 121, Art. 9(2); Mexico-Canada Treaty, *supra* note 120, Art. 9(2). The Canada-U.S. Treaty also requires that, within six years from the close of the taxable year to which the adjustment relates, the competent authority of the other State be notified in writing of the adjustment. Canada-U.S. Treaty, *supra* note 122, Art. IX(3). The Mexico-Canada Treaty requires that any adjustments made by a Contracting State cannot be made after the time limits provided in its nation's laws and, in any case, not after five years from the end of the taxable year the income or profits accrued. Mexico-Canada Treaty, *supra* note 120, Art. 9(3). Generally, an

The Associated Enterprises Article appeared to generate very little controversy between the two original free-trade partners, Canada and the United States, until the enactment of proposed transfer pricing regulations by the United States in 1992 and temporary regulations in 1993. The proposed and temporary regulations included, among other items, detailed provisions with respect to periodic adjustments rules and profit based transfer pricing methods, including the comparable profits method and the profit split method. Further, the Omnibus Budget Reconciliation Act of 1993[333] contained severe penalties in the event of transfer pricing adjustments.[334] As the position taken by the United States, including the requirements for periodic adjustments and the comparable profits methods, conflicted with the approaches adopted by other OECD countries to transfer pricing, a special task force was formed by the OECD to comment on the U.S. regulations. In addition, Canada issued a statement prepared by Revenue Canada and the Canadian Department of Finance both expressing disapproval of the comparable profits method and periodic adjustment provisions, and warning that Revenue Canada would not provide corresponding adjustments in most cases.[335]

Ongoing discourse between the United States and the OECD task force resulted in final transfer pricing regulations released by the U.S. Treasury Department in 1994[336] and OECD transfer pricing guidelines released in 1995[337] that can loosely be described as compatible. Nonetheless, the OECD guidelines continue to indicate strong reservations about the application by the United States of periodic adjustments, the use of the comparable profits method, and the breadth and severity of the penalty provisions.[338] Since much of the controversy focuses on the transfer or use of intangibles and the provision of services, it is widely expected that transfer pricing problems will continue to plague Canada-U.S. relations in the cross-border

adjustment will not be made in any case of fraud, willful default, neglect or gross negligence. Canada-U.S. Treaty, *supra* note 122, Art. IX(5); U.S.-Mexico Treaty, *supra* note 121, Art. 9(3); Mexico-Canada Treaty, *supra* note 120, Art. 9(4).

[333] Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13236, 107 Stat. 312, 505 (1993).

[334] *See supra* note 274 and accompanying text (discussing U.S. transfer pricing rules with regard to the allocation of business profits); BLESSING, *supra* note 167, ¶ 7.01[2] (discussing the U.S. transfer pricing rules).

[335] DEPARTMENT OF FINANCE - IMMEDIATE RELEASE, Ottawa, January 7, 1994, 94-003, *Transfer Pricing Rules and Guidelines Clarified*, *reprinted in* 23 TAX MGMT. INT'L 147 (1994). *See generally* BLESSING, *supra* note 167, ¶ 7.02[1][b] (discussing the development of the conflict between the U.S. and the OECD regarding transfer pricing).

[336] Treas. Reg. § 1.482 (as amended in 1996).

[337] ORG. FOR ECON. CO-OPERATION AND DEV., TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (1995). The original version of the report was approved by the Committee on Fiscal Affairs of the OECD on June 27, 1995.

[338] *See* BLESSING, *supra* note 167, ¶ 7.02[1][b] (discussing the worldwide development of transfer pricing rules).

transfer of technology. Canada[339] and Mexico[340] also recently enacted transfer pricing rules to prevent erosion of their tax bases through a perceived bias towards compliance with the U.S. rules in order to avoid U.S. penalties. As can be seen, transfer pricing issues are, and will continue to be, a major concern in technology transfer arrangements in all three NAFTA countries.

8. Article XXV: Non-Discrimination

Generally, the Non-Discrimination Articles of the three tax treaties prevent one Contracting State from imposing taxation on a citizen or the permanent establishment of enterprises of the other State that is additional or more burdensome than the Contracting State imposes on its own citizens, or the citizens or permanent establishments of any third State under the same circumstances. It imposes minimum obligations on the NAFTA partners with respect to discrimination in all taxes imposed by the United States, Canada or Mexico. The Non-Discrimination Articles are similar to the national treatment and most-favored-nation treatment provisions found in the WTO Agreement and NAFTA.[341]

The Non-Discrimination Articles protect citizens of a Contracting State from discrimination by the other State in tax matters. Specifically, the Articles provide that a citizen of a Contracting State that is a resident of the other State may not be subject to a more burdensome tax treatment in that other State.[342] Further, even if a citizen of a Contracting State is not a resident of the other State, that citizen may not be subject in the other State to tax treatment more burdensome than the tax treatment a citizen of any third State is subject.[343] Thus, Canadian taxation of a citizen and resident of the United States while in Spain cannot be more burdensome than the Canadian taxation of a Spanish citizen and resident in Spain. Any benefits available to the Spanish citizen and resident by virtue of an income tax convention between Canada and Spain must be available to the citizen and resident of the United States while in Spain.[344] Business ventures where the capital of the company is wholly or partly owned by a resident of a Contracting State, or controlled, by one or more residents of the other State are provided pro-

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[339] I.T.A. § 247.

[340] Mexico Income Tax Law, Articles 64, 64A, 65, 65A and regulations, *reprinted in* 2 TAX LAWS OF THE WORLD–MEXICO 67-70 (2000).

[341] See *supra* Part II (discussing multilateral intellectual property trade and service provision agreements).

[342] Canada-U.S. Treaty, *supra* note 122, Art. XXV(1); U.S.-Mexico Treaty, *supra* note 121, Art. 25(1); Mexico-Canada Treaty, *supra* note 120, Art. 23(1).

[343] Canada-U.S. Treaty, *supra* note 122, Art. XXV(2); U.S.-Mexico Treaty, *supra* note 121, Art. 25(1); Mexico-Canada Treaty, *supra* note 120, Art. 23(1).

[344] Can.-U.S. Treas. Tech. Expl., *supra* note 216, Art. XXV.

tection against tax discrimination,[345] and a permanent establishment located in the other State cannot be taxed less favorably than that of an enterprise of the Contracting State carrying on the same activities.[346] Additionally, there is an obligation to provide a deduction for interest and royalties, and other disbursements paid by an enterprise of one State to a resident of the other State in calculating taxable profits under the same conditions as if they had been paid to a resident of the same State.[347] Finally, non-discrimination extends to all taxes imposed by a Contracting State.[348]

9. *Mutual Agreement, Competent Authority, Arbitration and Exchange of Information*

Tax treaties provide a degree of certainty and predictability in allowing taxpayers to arrange their cross-border activities with some assurance as to tax treatment. The clarification of tax jurisdiction and the mutual agreement procedures for resolving conflicts contained in the tax treaties alleviate many of the problems that arise for a taxpayer dealing with different tax systems. The provision in the tax treaties for the exchange of information between states also helps treaty partner countries enforce their domestic tax provisions.[349]

All of the bilateral tax treaties signed among the NAFTA signatories contain a provision establishing a Mutual Agreement Procedure[350] for resolving treaty disputes. This procedure is also the umbrella for a number of important aspects of taxpayer relief. For example, under the Mutual Agreement Procedure, if a taxpayer believes the actions of one or both of the Contracting States will result in taxation not in accordance with the provisions of the treaty, the taxpayer may present the case in writing to the

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[345] Canada-U.S. Treaty, *supra* note 122, Art. XXV(5); U.S.-Mexico Treaty, *supra* note 121, Art. 25(5); Mexico-Canada Treaty, *supra* note 120, Art. 23(4).

[346] Canada-U.S. Treaty, *supra* note 122, Art. XXV(6); U.S.-Mexico Treaty, *supra* note 121, Art. 25(2); Mexico-Canada Treaty, *supra* note 120, Art. 23(2).

[347] Canada-U.S. Treaty, *supra* note 122, Arts. XXV(7)-(8); U.S.-Mexico Treaty, *supra* note 121, Art. 25(4). The Mexico-Canada Treaty does not contain this provision.

[348] Canada-U.S. Treaty, *supra* note 122, Art. XXV(10). The Non-Discrimination Article of the U.S.-Mexico Treaty extends coverage to "all taxes imposed by a Contracting State or political subdivision or local authority thereof." U.S.-Mexico Treaty, *supra* note 121, Art. 25(6). The Mexico-Canada Treaty limits non-discrimination to taxes that are subject to the treaty. Generally, under Article 2 (Taxes Covered), the taxes covered by the treaty are taxes on income. *See* Mexico-Canada Treaty, *supra* note 120, Art. 23(5).

[349] Canada-U.S. Treaty, *supra* note 122, Art. XXVII; U.S.-Mexico Treaty, *supra* note 121, Art. 27; Mexico-Canada Treaty, *supra* note 120, Art. 25. The Convention Between the Government of Canada and the Government of the United Mexican States for the Exchange of Information with Respect to Taxes signed on March 16, 1990, in Mexico City, came into force on April 27, 1992. "Its provisions will have effect in respect of taxes that become payable on or after January 1, 1993." 2 CANADA'S TAX TREATIES 15,295 (Butterworths 1992).

[350] Canada-U.S. Treaty, *supra* note 122, Art. XXVI; U.S.-Mexico Treaty, *supra* note 121, Art. 26; Mexico-Canada Treaty, *supra* note 120, Art. 24.

competent authority of the State in which the taxpayer is a resident or national.[351] If relief appears to be justified and the Contracting State of residency cannot arrive at a satisfactory solution, the competent authorities of both Contracting States will attempt to resolve the case by mutual agreement.[352] In addition to attempting to resolve disputes arising as to the interpretation or application of a provision in a tax treaty, the competent authorities of the Contracting States may consult together regarding disputes not provided in the three tax treaties.[353] The Mutual Agreement Procedures of the Canada-U.S. Treaty and the U.S.-Mexico Treaty also contain at least the potential for binding arbitration if a dispute cannot be resolved.[354]

The availability of competent authority assistance is not limited to the situations stated in the treaty articles establishing the Mutual Agreement Procedures. Authority to grant relief may be specially provided in other

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[351] Canada-U.S. Treaty, *supra* note 122, Art. XXVI(1); U.S.-Mexico Treaty, *supra* note 121, Art. 26(1); Mexico-Canada Treaty, *supra* note 120, Art. 24(1). Unfortunately, there is no requirement that the mutual agreement procedure result in the resolution of the dispute, only that the two governments agree to attempt to resolve the dispute. This procedure, therefore, offers few guarantees to the taxpayer. In fact, the taxpayer does not have the right to participate in the proceedings. The only real role the taxpayer is guaranteed is that of providing documentation.

[352] Canada-U.S. Treaty, *supra* note 122, Art. XXVI(2); U.S.-Mexico Treaty, *supra* note 121, Art. 26(2); Mexico-Canada Treaty, *supra* note 120, Art. 24(2). Further, the Canada-U.S. Treaty provides that the agreement reached will be implemented notwithstanding any time limitations in the domestic laws of the Contracting States, provided that the competent authority of the Contracting State of non-residency receives notification of the existence of the case "within six years from the end of the taxable year to which the case relates." Canada-U.S. Treaty, *supra* note 122, Art. XXVI(2). The Mexico-Canada Treaty prohibits income adjustments by the other Contracting State after five years from the end of the taxable period to which the income relates. Mexico-Canada Treaty, *supra* note 120, Art. 24(3). The Treaty between the United States and Mexico provides that the competent authority of the Contracting State of non-residency must be "notified of the case within four and a half years from the due date or the date of filing of the return in [the non-residency] State, whichever is later." Any agreement reached will be "implemented within ten years from the due date or the date of filing of the return . . . , whichever is later, or a longer period if permitted by the domestic law of [the non-residency] State." U.S.-Mexico Treaty, *supra* note 121, Art. 26(2).

[353] The Canada-U.S. Treaty expressly authorizes the competent authorities to agree on certain designated topics and states that the Canadian and U.S. competent authorities may consult one another regarding cases not provided for within the Convention. Canada-U.S. Treaty, *supra* note 122, Art. XXVI(3). The U.S.-Mexico Treaty merely authorizes the Competent Authorities to consult together concerning cases not provided for in the Treaty. U.S.-Mexico Treaty, *supra* note 121, Art. 26(3). Similarly, the Mexico-Canada Treaty provides for resolution by mutual agreement of any difficulties or doubts arising as to the interpretation or application of the Treaty. Mexico-Canada Treaty, *supra* note 120, Art. 24(4).

[354] Canada-U.S. Treaty, 1995 Protocol, *supra* note 122, Art. XXVI(6); U.S.-Mexico Treaty, *supra* note 121, Art. 26(5). Both treaties provide that the voluntary arbitration procedure will have effect only after the contracting countries have agreed through the exchange of diplomatic notes. *See* Canada-U.S. Treaty, 1995 Protocol, *supra* note 122, Art. XXVI(6); U.S.-Mexico Treaty, *supra* note 121, Art. 26(5).

provisions of a treaty. For example, the Canada-U.S. Treaty permits tax-payers to request deferment of profit, gain or income with respect to property alienated in the course of a corporation or other organization, reorganization, amalgamation, division or similar transaction in order to avoid double taxation;[355] the Mexico-Canada Treaty permits a deferral with respect to gains on the alienation of shares on an amalgamation, reorganization or division.[356] These provisions are disparate from the typical Mutual Agreement Procedure in that tax relief is sought from the competent authority of the non-resident, and not the resident, Contracting State.[357]

V. CONCLUSION

While the WTO Agreement and NAFTA have eliminated many of the tariff and nontariff barriers to trade, and the bilateral tax treaties among the NAFTA partners serve a valuable function in reducing the potential of double taxation, significant issues remain outstanding. One of the most obvious is the disparity in tax treatment by the tax treaties of certain types of income, particularly with respect to the withholding tax on royalties and the tax treatment of payments for services. Unfortunately, the country most negatively affected by these disparities is Mexico, a nation which could best utilize the technology of its NAFTA partners. Difficulties in the interpretation of the Royalties Article also continue, particularly in determining its scope, notwithstanding its critical role in the cross-border flow of technology between the NAFTA parties. Uncertainty surrounding the Article's application is further exacerbated by the imposition of a selective withholding tax on royalty payments.

With respect to the protection of intellectual property and services, issues such as the interpretation of commitments under GATS and TRIPS and the related Chapters in NAFTA continue to provide challenges as Member countries seek new markets. Further, the right to access the various dispute settlement mechanisms under these international agreements requires clarification, in particular whether all tax related disputes must be brought under the mutual agreement procedure of the tax treaties or whether areas remain where resolution can be sought under the provisions of the WTO Agreement or NAFTA. The provision of tax subsidies to local service providers under domestic legislation provides one area ripe for such a challenge.

The relationship between the trade agreements and the tax treaties, a relationship that will no doubt profoundly affect the environment in which businesses operate within the NAFTA block, also remains to be evaluated. There is little doubt that obligations assumed under the trade agreements

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[355] Canada-U.S. Treaty, *supra* note 122, Art. XIII(8).

[356] Mexico-Canada Treaty, *supra* note 120, Art. 13(5).

[357] Canada-U.S. Treaty, *supra* note 122, Art. XIII(8); Mexico-Canada Treaty, *supra* note 120, Art. 13(5).

will have application to tax matters in ways that were not anticipated when the states entered into these trade agreements. Conversely, tax legislation can both raise impediments to trade or provide trade distorting subsidies far more egregious than practices prohibited in trade agreements. Tax treaties can also reverse the benefits of most-favored-nation treatment and affect the national treatment obligations that are critical to trade law discipline. This relationship and its potentially significant side effects has not been explored.

Coordination between the various trade agreements and tax treaties is one option for the NAFTA partners. However, notwithstanding a commonality of goals among nations, trade agreements and tax treaties are shaped by radically different environments. Obligations appropriate under the trade agreements may not be in a context where national tax policies are at issue. Finding an appropriate balance between preventing trade discrimination and allowing flexibility in achieving domestic tax goals may, thus, prove a daunting and lengthy task. In the interim, an important challenge for tax and trade law reformers as well as tax advisors will be a continuous evaluation of both the intended and unintended impact of trade agreements and tax treaties within the NAFTA block and search for solutions to minimize potentially harmful effects to the NAFTA parties.