Law and Business Review of the Americas

Volume 9 | Number 3 Article 4

2003

# Weaving the Continental Web: Exploring Free Trade, Taxation, and the Internet

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Aldo Forgione, *Weaving the Continental Web: Exploring Free Trade, Taxation, and the Internet*, 9 Law & Bus. Rev. Am. 513 (2003)
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# WEAVING THE CONTINENTAL WEB: EXPLORING FREE TRADE, TAXATION, AND THE INTERNET

*Aldo Forgione**

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## I. INTRODUCTION

THE North American Free Trade Agreement (NAFTA) created the world's largest regional economic bloc when it was signed in 1992.[1] The ink on NAFTA was barely dry before pleas for expansion of the free trade pact led to concentrated negotiations for greater economic liberalization within the hemisphere. At the 1994 Summit of the Americas, held in Miami, Florida, thirty-four heads of state from Latin America agreed to initiate a formal negotiation process aimed at completing a Free Trade Area of the Americas agreement by 2005.[2] As NAFTA's first decade nears its end, it has become critically important for North American trade representatives to address a variety of challenges prior to concluding an expansive Free Trade Agreement of the Americas.[3]

1. North American Free Trade Agreement Between the Government of Canada, the Government of the United Mexican States and the Government of the United States of America, 32 I.L.M. 605 (1993) (Signed by the Heads of State of each of the three countries on December 17, 1992 [hereinafter NAFTA or the Free Trade Agreement].
2. The 1994 declaration to engage in negotiations to establish a Free Trade Area of the Americas (FTAA) was reaffirmed in the Second Summit of the Americas Declaration of Santiago (Apr. 19, 1998) (where Heads of State and Governments reaffirmed their "determination to conclude the negotiation of the FTAA no later than 2005, and to make concrete progress by the end of the century"), as well as at the Fifth Ministerial Meeting held in Toronto, Canada, in November 1999; *see* Fifth Trade Ministerial Meeting, *Free Trade Area of the Americas Declaration of Ministers*, 6 NAFTA: L. & BUS. REV. AM. 471 (2000).
3. Although NAFTA was signed by the leaders of the Governments of Canada, Mexico, and the United States in December, 1992, the provisions of the Agreement did not take effect until it had been ratified by each Member State. NAFTA came into

NAFTA's failure to implement effective tax integration within North America complicates the free flow of goods and services across borders.[4] The current tax treatment of cross-border transactions within North America often proceeds without reference to the basic tenets of NAFTA. Moreover, the advent of electronic commerce challenges the efficacy of certain aspects of the Free Trade Agreement.[5] Electronic commerce challenges the practical benefits of trade agreements that are preoccupied with the exchange of physical goods and services. Furthermore, the growth of the digital economy has exacerbated the difficulties arising out of the application of outdated and disharmonious tax rules in a liberalized trade environment.

This article starts by considering the interaction of tax policy, free trade agreements, and electronic commerce. Part II introduces the primary objectives of trade liberalization and reviews the trade policy developments that led to the signing of NAFTA. The concepts of mutual advantage and harmonization, as well as other core trade principles, are discussed within the taxation framework set out in the monumental North American Free Trade Agreement. Review of NAFTA's history and its objectives allows for improved evaluation of the feasibility and, indeed, the desirability of extending the scope of the continental Free Trade Agreement to encompass all or part of the Americas.

Part III explores the interdependence between tax treaties and international trade policies.[6] The NAFTA objective of harmonization infers integration of national taxation and trade policies. Ambiguous or contradictory tax rules create artificial biases and uncertainty for international transactions.[7] An argument will be made that prevailing international tax rules detract from the paramount principles of mutual

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force on January 1, 1994. Therefore, the first decade where NAFTA governed the continental trade of goods and services will be fully completed on December 31, 2003.

4. *See* Arthur J. Cockfield, *Tax Integration Under NAFTA: Resolving the Conflict Between Economic and Sovereignty Interests*, 34 STAN. J. INT'L L. 39, 69 (1998) (noting that the absence of tax integration in NAFTA could have various adverse long term effects).
5. *See generally* J. Barrett Willingham, *Electronic Commerce and the Free Trade Area of the Americas*, 6 NAFTA: L. & BUS. REV. AM. 483 (2000) (where it is indicated that the FTAA needs to expressly respond to the e-commerce issues that have emerged since NAFTA was signed).
6. How policymakers weigh the importance of the interdependence of tax and trade issues will materially affect whether individuals, firms, countries and the world as a whole will benefit from free trade negotiations and the wealth of information technologies. Catherine L. Mann, *Balancing Issues and Overlapping Jurisdictions in the Global Electronic Marketplace: The UCITA Example*, 8 WASH. U.J.L. & POL'Y 215 (2002) (exploring how the Uniform Computer Information Transactions Act traces the tension of policymaking in an increasingly global, digital and information-based marketplace).
7. Mauricio Monroy, *Harmonizing the Mexican Tax System with the Goals of the North American Free Trade Agreement (NAFTA)*, 35 SAN DIEGO L. REV. 739, 740 (1998) (claims that "[f]ree trade is stifled by the presence of adverse tax policies, high tax rates on cross-border transactions, situations that cause double taxation, and uncertainty due to the lack of adequate rules governing international transactions.").

advantage and harmonization that form the basis of ongoing free trade negotiations.[8] The merits of this proposition will be considered using a detailed analysis of certain international income tax rules adopted by Canada, Mexico, and the United States. Since each of these countries are signatories to NAFTA, the lack of congruous income tax treatment of multinational business transactions challenges the efficacy of a continental free trade pact.

Part IV of this article reviews how the emergence of electronic commerce serves to exacerbate the difficulties encountered by tax authorities that seek to apply conflicting tax rules in an increasingly global and digital marketplace. The interdependence of tax and trade rules is embodied in the continuing free trade debate regarding electronic commerce. The resolution of issues regarding the taxation of electronic commerce will have important implications on the direction and growth of trading relations. The existing disparities in the production and use of information technologies across the Americas could detrimentally impact the treasuries of the parties to the Free Trade Agreement if prevailing tax rules are maintained. Free trade negotiators need to adopt equitable and neutral rules for the taxation of electronic commerce in order to prevent revenue losses that could further a "digital divide" between trading nations.[9]

Part V concludes with proposals that emphasize the need for gradual harmonization of continental tax and trade rules. A multilateral tax agreement involving Canada, Mexico, and the United States could be used to promote the NAFTA objectives of mutual gain and uniformity of treatment. Considerable emphasis must be given to the importance of tax integration as an adjunct to continuing continental free trade negotiations, particularly against the backdrop of the growth of digital commerce. If NAFTA or the prospective Free Trade Agreement of the Americas is to govern trade in an increasingly digital environment, then e-commerce must be governed by clear, harmonious, and mutually advantageous tax measures in the same manner as traditional modes of commerce.[10]

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8. The argument that bilateral tax conventions create duplicitous, unnecessary, and ineffectual barriers to international trade in goods and services builds upon the proposition established in Cockfield, *supra* note 4, at 40 ("that the movement toward freer regional trade and investment under NAFTA ought to be complemented by the gradual harmonization of North American tax regimes.").
9. The term "digital divide" refers to the disparity or gap between countries and individuals that have access to information technologies and electronic commerce and those countries and individuals that do not. For discussion as to the need to overcome the digital divide between countries, *see* J.M. Spectar, *Bridging the Global Digital Divide: Frameworks for Access and the World Wireless Web*, 26 N.C. J. INT'L L. & COM. REG. 57 (2000). To review a political plan that purports to address the disparity of access to information technologies within the United States, *see* The White House, THE CLINTON-GORE ADMINISTRATION: FROM DIGITAL DIVIDE TO DIGITAL OPPORTUNITY, Feb. 2, 2000, *available at* http://www.digitaldivide.gov/2000-02-02.html [hereinafter CLINTON-GORE].
10. In a previous article, I argued for the need to reform international tax rules for electronic commerce in a manner that adhered to accepted tax policy principles of neutrality and inter-nation equity. *See* Aldo Forgione, *Clicks and Mortar: Taxing*

## II. REVISITING NAFTA - A DECADE LATER

The North American Free Trade Agreement completes its first decade on December 31, 2003. NAFTA came about as a result of a special blend of historical antecedents. The Governments of Canada, Mexico and the United States entered into NAFTA in order to eliminate distortions to continental trade. More than any other international trade agreement, NAFTA symbolized a revolutionary step towards acceptance of the economic possibilities of the time. The Free Trade Agreement was made possible due to unusual political conditions and the implied acceptance by each of the three countries of their respective roles in trade and geopolitical relations in the region and the world.[11] This part reviews some of the objectives and trade principles espoused by NAFTA as well as the international tax and trade developments that took place in the Member States during the first ten years of the Free Trade Agreement.

### A. Objectives of the Free Trade Agreement

NAFTA was heralded as the beginning of a new era of economic cooperation and trade amongst the nations of North America. The Preamble to NAFTA promotes the concepts of mutual advantage and harmonization of treatment as fundamental components of the reciprocal trade relations of the signatories to the Free Trade Agreement.[12] For the first time ever, a relatively poor developing country agreed to open its economy and expose its businesses to unprecedented competition with two industrialized countries. The Free Trade Agreement sought to overcome concerns regarding the impact of economic disparities between its Member States by establishing clear and harmonized rules that would promote mutually advantageous trade flows within North America. This section will explore how from its complex origins, NAFTA strove to fulfil its objective of harmonization of trade rules and the promise of mutual gain for each of its signatories.

#### 1. *Mutual Advantage*

*"Any new pattern of economic relations must ensure the mutuality of benefits. A plan which concentrates all or most of the economic gain*

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*Multinational Business Profits in the Digital Age*, 26 Seattle Univ. L. Rev. 719 (2003) ("Income from e-commerce ("clicks") should be treated in a similar manner to traditional business income ("mortar").").

11. For discussion of how the circumstances and changes that accompanied NAFTA profoundly impacted trade negotiations throughout the Americas, *see* Sergio Lopez-Ayllon, *Mexico's Expanding Matrix of Trade Agreements -A Unifying Force?* 5 NAFTA: L. & Bus. Rev. Am. 241, 242 (1999).

12. The Preamble to NAFTA states that the parties to the Agreement are resolved to, among other things, establish rules that promote "clear and mutually advantageous trade, and assur[e] a predictable commercial framework for business planning and investment." The objectives set out in the Preamble, which represent resolutions undertaken by the governments of Canada, Mexico, and the United States, are meant to "inspire the entire text of NAFTA." *See* Monroy, *supra* note 7, at 740.

*in one party and all or most of the economic sacrifice in another, cannot be expected to endure."*[13]

NAFTA was the first comprehensive free trade agreement concluded between two of the most developed economies in the world, the United States and Canada, and a much less developed country, Mexico. NAFTA challenged the notion that a developing country could not benefit from a reciprocal trade agreement involving wealthy and industrialized nations. Soon after the commencement of continental trade negotiations, it became clear that Mexico had to overcome huge economic and investment disparities if it was to participate on a reciprocal level in its trade relations with the United States and Canada.[14] NAFTA was presented as a way to provide economic gains to a poor country while alleviating the disparity among the trading nations in the bloc.[15] Based on the premise that there is a positive correlation between free trade and economic development, mutually advantageous trade rules could serve to narrow the gap between poor and rich countries.[16]

One of the most important criteria for determining the success of NAFTA is whether the historic Free Trade Agreement was able to achieve its ambitious objective of mutual advantage for its Member States. . Basically, has NAFTA contributed to or promoted the fiscal well-being of each of its parties during its first decade? While we may not yet have a definitive reply to this critical question, it appears that the governments of the NAFTA signatories are pleased with the economic progress made by their respective nations. The economic performance of the United States during NAFTA's first decade was extremely strong and, according to its primary trade representative, the Free Trade Agreement

13. Opening statement of Senator Sarbanes, Joint Economic Committee—Hearing Before the Congress of the United States, *reprinted* in AMERICAN ECONOMIC POLICIES TOWARD MEXICO AND LATIN AMERICA 2 (Sept. 17, 1990).
14. In 1991, before the Free Trade Agreement was concluded, the levels of North American trade (measured in U.S. Dollars) were as follows: U.S.-Canada, $143 billion; Mexico-U.S., $64 billion; and Mexico-Canada, $3 billion. More indicative of the economic power imbalance faced by Mexico was the fact that U.S. direct investment in Mexico amounted to $11.6 billion in 1991, while Mexican direct investment in the United States amounted to only $0.6 billion. By comparison, U.S. investment in Canada at that time amounted to $68.5 billion, but the amount of reciprocal Canadian investment in the U.S. reached $30 billion in 1991. *See* Dean C. Alexander, *The North American Free Trade Agreement: An Overview*, 11 INT'L TAX & BUS. LAW. 48, 49 (1993).
15. "The NAFTA approach, of a conventional free trade area supplemented by investment, services and carefully delimited temporary entry provisions (instead of full labor mobility), could prove more flexible in facilitating regional economic integration when countries have different income levels." Murray Smith, *The North American Free Trade Agreement: Global Impacts*, *in* REGIONAL INTEGRATION AND THE GLOBAL TRADING SYSTEM 85 (Kym Anderson & Richard Blackhurst eds., 1993).
16. "Developing countries that have been most open to trade have had the fastest growth, reducing global inequality; those least integrated into global markets, such as many African economies, have remained among the world's poorest." Nancy Birdsall, *Life is Unfair: Inequality in the World*, 111 FOREIGN POL'Y 76, 85 (1998) (indicating that liberalized trade and economic integration reduce inequality and foster economic growth).

provided important contributions to this economic success.[17] Canadian trade authorities report that that "since 1994, investment in NAFTA countries has been dynamic" leading to mutual gains in employment and increased trade.[18] By several accounts, Mexico has derived the greatest proportion of economic benefits from the Free Trade Agreement.[19]

NAFTA's promise of mutual advantage for each of its members has been trumpeted as the basis for the expansion of the Free Trade Agreement to Latin American nations.[20] However, it is unclear whether the trade liberalization movement that swept the Americas in the 1990s has provided any material improvements in the economic welfare of most Latin Americans. Many countries in Central and South America shifted to open trading policies as exemplified by the proliferation of regional

17. In her 2000 Report, Ambassador Charlene Barshefsky, United States Trade Representative, indicated that U.S. foreign trade policy, in general, and NAFTA, in particular, contributed largely to the following achievements: a 55% expansion of American goods and services exports since 1992 to $958.5 billion in 1999; U.S. economic growth of $2.1 trillion or 28.7% from $7.2 trillion in 1992 to $9.3 trillion in 1999; U.S. employment growth of approximately twenty-one million jobs, with unemployment levels dropping from 7.3% to 4.1% in 2000 being the lowest unemployment rate since January 1970; rising American living standards as hourly wages for non-supervisory workers increased 6.2% since NAFTA took effect; U.S. non-residential business investment increased by 10.4% per year from 1994; and, since 1992, U.S. industrial growth increased 40.5% with growth in manufacturing production accounting for an additional $400 billion (by comparison, Germany's total industrial growth in the same period was only 6.3% and Japan's 3.6%). "Since the NAFTA, trade among the three signatories has expanded by more than 85%, including goods export growth of $76 billion to Canada, and $46 billion to Mexico. Since 1998, Mexico has been our second largest trading partner after Canada." Ambassador Charlene Barshefsky, United States Trade Representative, Testimony before the House Appropriations Subcommittee on Commerce, Justice, State, The Judiciary and Related Agencies (Apr. 5, 2000), 2000 WL 365138 F.D.C.H.

18. According to figures compiled by the Canadian government, NAFTA has corresponded with the creation of more jobs in each of the Member States: employment up 28% in Mexico; up 16% in Canada; and an increase of 12% in the United States from January, 1994 levels. Furthermore, since 1994, the United States has doubled the amount of trade with Mexico and Canada; Canadian trade to the region increased over 109% during that period; and Mexican trade to the U.S. and Canada exploded by over 238% from its 1994 level. *See* Canada-Department of Foreign Affairs and International Trade, NAFTA AT SEVEN: BUILDING ON A NORTH AMERICAN PARTNERSHIP [hereinafter NAFTA AT SEVEN], *available at* http://www.dfait-maeci.gc.ca/nafta-alena/nafta_7-en.asp (last visited July 8, 2003).

19. Mexico's rates for job creation (employment increase of 28% over first seven years) and trade growth (up over 238%), according to NAFTA at Seven, *id.*, were considerably higher than comparable figures in the United States and Canada. Of course, Mexico started the 1990s with the standard of living of a developing country so percentage gains based on a relatively low base are not necessarily indicative of major economic gains for Mexico. Nonetheless, the Government of Mexico has embraced the mantle of trade liberalization as a key component of its plan for economic prosperity. Mexico has now signed thirty-two separate free trade agreements. *See* Mexico Trade Background, *at* http://www.ftaa-alca.org.

20. At the Summits of the Americas in Miami and Santiago it was declared that the Free Trade Area of the Americas (FTAA) would eliminate tariffs and non-tariff barriers to trade in goods and services throughout the Hemisphere and establish a single set of rules for fair trade in the region in order to promote "shared prosperity and mutual benefit." Barshefsky, *supra* note 17.

trade agreements and the multiplicity of declarations and commitments to the creation of the FTAA.[21] However, the economic performances of the nations in the region varied considerably during the past decade. Whereas the economies of Argentina, Chile, and Peru enjoyed growth at an annual rate of roughly 5 percent for most of the 1990s, countries like Colombia, Ecuador, Paraguay, and Venezuela lost or failed to gain ground during that period. Moreover, the 1990s represented the second consecutive decade during which the entire region's GDP growth per capita was less than 1.5 percent, "leaving most Latin Americans almost as poor in 2000 as they were in 1980."[22]

Even where free trade contributed to economic growth and an improvement in the average standard of living, the evidence suggests that the disparity between richest and poorest members of society increased throughout Latin America during the first decade of the Free Trade Agreement. Latin America currently suffers the worst income disparities of any region in the world surpassing those of even sub-Saharan Africa.[23] The ratio of income of the top 20 percent of earners to the bottom 20 percent is an average of sixteen to one in Latin America compared to about ten to one in the United States and about five to one in Western Europe.[24] These income disparities are especially disheartening as they accompany a period of unparalleled democratization and free trade in Latin America.

Taxation represents an essential mechanism for the amelioration of income disparities within a nation. In addition to its redistributive objectives, income tax revenues are often relied upon by governments tofinance infrastructure projects, promote economic growth, and to improve productivity. Tax measures constitute an essential ingredient in the promotion of domestic social policies. Therefore, taxation represents a critical fiscal tool for the alleviation of economic disparities that arise as a result of a liberalized trading regime.[25]

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21. For a listing of regional trade agreements involving countries in North and South America and other information regarding the Free Trade Area of the Americas, *at* http://www.ftaa-alca.org.
22. *See* Peter Hakim, *Is Latin America Doomed to Failure?* 117 FOREIGN POL'Y 104, 106 (2000) (noting that despite Latin America's economic restructuring and trade policy reforms, the economic performance in many Latin American countries fell short of expectations).
23. *Id.* (noting that "inequalities of income and wealth are worsening almost everywhere" in the region. In 2000, more than half of Latin America's national income went to only one-seventh of the population).
24. Brazil has the dubious distinction of the largest disparity in the world at approximately 25 to 1. Another disturbing trend involves the measure of the wage gap between skilled and unskilled workers, which increased in the 1990s by more than 30% in Peru, 20% in Colombia, and nearly 25% in Mexico. Ironically, these countries enjoyed the greatest wage increases in Latin America during that period. Hunter R. Clark & Amanda Velazquez, *Foreign Direct Investment in Latin America: Nicaragua - A Case Study*, 16 AM. U. INT'L L. REV. 743, 754-55 (2001).
25. *See* Brian J. Arnold, Jacques Sasseville, and Eric M. Zolt, *Summary of the Proceedings of an Invitational Seminar on Taxation of Business Profits Under Tax Treaties*, 50 CAN. TAX J. 1979, 1981-83 (2002) (noting that trade globalization has increased the importance of corporate income tax revenues, especially for developing coun-

On an international level, tax rules and principles provide a mechanism for the flow of revenues between nations. Since the United States, Canada, and Mexico each provide unilateral relief from double taxation in their domestic tax regimes, the division of tax claims between treaty partners is a significant determinant in the allocation of tax revenues among the countries in the North American trading bloc. Bilateral tax treaties offer the means by which a nation can gain a fiscal advantage over its treaty partner.[26] In so far as NAFTA defers jurisdiction over tax measures to bilateral tax treaties involving its Member Nations, the Free Trade Agreement allows some fiscal matters to trump the objective of mutual advantage that is supposed to bind its trading nations.[27]

### 2. *Harmonization of Trade and Tax Rules*

The North American Free Trade Agreement is predicated on the belief that tariffs and taxation measures create barriers to the cross-border movement of goods and services between territories.[28] Free market economic theorists indicate that double taxation, under taxation and the disharmonious application of transactional tax rules create problematic distortions in international trade and commerce.[29] The Free Trade Agreement followed upon negotiations that took place under the auspices of the now-defunct General Agreement on Trade and Tariffs.[30] Like its European counterpart, NAFTA strove to create an integrated and comprehensive trading bloc through the adoption of uniform rules and practices.[31]

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tries). The redistribution of wealth is an implicit feature of most income tax systems in existence today. The progressive rate structure based on the ability-to-pay concept is generally designed to promote the welfare of a country's nationals by utilizing the tax revenues for social transfers

26. PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, ECONOMICS 836 (12th ed. 1985) (making the argument that double taxation inhibits international division of labor, slows international economic growth and undermines the policies of trade treaties such as GATT). *See also generally*, United States International Trade Commission, POTENTIAL IMPACT ON THE U.S. AND SELECTED INDUSTRIES OF THE NORTH AMERICAN FREE TRADE AGREEMENT (Jan. 1993).
27. NAFTA, *supra* note 1, art. 2103, para.1 provides that: "Except as set out in this Article, nothing in this Agreement shall apply to taxation measures." In recognition of the importance of national tax sovereignty, NAFTA defers determinations of the appropriateness of various tax measures to the domestic tax laws of its member countries. *See* Cockfield, *supra* note 4.
28. *See* NAFTA, *supra* note 1, art. 1.02 (Objectives).
29. SAMUELSON & NORDHAUS, *supra* note 26, at 836 (making the argument that double taxation inhibits international division of labor, slows international economic growth and undermines the policies of trade treaties such as GATT). *See also generally* UNITED STATES INTERNATIONAL TRADE COMMISSION, POTENTIAL IMPACT ON THE U.S. AND SELECTED INDUSTRIES OF THE NORTH AMERICAN FREE TRADE AGREEMENT (Jan. 1993).
30. General Agreement on Tariffs and Trade, Oct. 30, 1947, 55 U.N.T.S. 194 (1950) [hereinafter GATT].
31. Unlike GATT and other trade agreements, NAFTA sought to mandate cooperation to protect the environment and workers' rights by providing sanctions for ineffective enforcement of labor and environmental commitments. NAFTA strives

NAFTA's support for the harmonization of trade and tariff rules among its signatories does not expressly extend to taxation measures. The Free Trade Agreement recognizes that the national sovereignty concerns of Member States may from time to time override the liberalized trade regime set out in NAFTA.[32] Basically, the Free Trade Agreement currently permits its rules and principles to be trumped by bilateral income tax treaties and other domestic tax measures.[33] There is legitimate concern that in the absence of formal harmonization of the tax systems of the Member States, tax competition for cross-border investment flows will adversely affect the NAFTA countries.[34] Furthermore, the Free Trade Agreement prescribes that reference to the bilateral tax treaties of the member countries is required to determine the application of appropriate income tax rules.[35] By making express reference to the preeminence of the bilateral tax conventions of NAFTA's member countries, the Free Trade Agreement avoids the task of establishing tax rules. So although NAFTA fundamentally changed the nature of trade and investment throughout the continent, the agreement did not establish new rules or mechanisms for taxing cross-border activities.

The absence of tax congruity within NAFTA was exacerbated by the arrival of technological innovations that widened the differential application of tax rules to continental trade flows. The growth of electronic commerce blurred the use of traditional source rules resulting in lack of harmonization in the tax and trade treatment of Internet transactions as opposed to conventional business transactions. Since source of income rules constitute a primary determinant of which country is entitled to tax the income arising from a particular cross-border activity, the source of income rules of the NAFTA countries must be consistent if the goal of economic neutrality is to be fully achieved.[36] The lack of harmonization of treatment between e-commerce and conventional business activities opens the door to a series of additional problems. The application of

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to be more than a free trade agreement, but stays away from the harmonization of socio-political norms proposed by the European Union.

32. *See* Cockfield, *supra* note 4, at 49-58 (for an explanation of why NAFTA negotiators opted to cede tax integration in order to accommodate the sovereignty concerns of the NAFTA Member States).
33. NAFTA, *supra* note 1, art. 2103, para. 2. For instance, Clause 2104(4)(c) of NAFTA declares that nothing in the Agreement shall apply any most-favored-nation obligation with respect to an advantage accorded by a party pursuant to a tax convention.
34. Cockfield, *supra* note 4, at 43-44.
35. NAFTA, *supra* note 1, art. 2103, para. 2 provides: "Nothing in this Agreement shall affect the rights and obligations of any Party under any tax convention. In the event of any inconsistency between this Agreement and any such convention, that convention shall prevail to the extent of the inconsistency."
36. Michael S. Schadewald & Tracy A. Kaye, *Source of Income Rules and Treaty Relief From Double Taxation Within the NAFTA Trading Bloc*, 61 LA. L. REV. 353, 355 (2001) (wherein it is explained that as the level of trade and investment among signatories to NAFTA continues to grow, the NAFTA countries will experience greater pressure to harmonize their respective tax systems and particularly their source of income rules).

separate or different tax rules to e-commerce transactions could lead to the creation of artificial biases in the marketplace. Disharmony in the tax treatment prescribed by the Member States will hinder the economic efficiencies sought by the Free Trade Agreement.[37]

It is difficult to justify the dichotomous treatment of tax and tariff measures within the Free Trade Agreement. NAFTA represented a multilateral effort by the largest nations of North America to reduce customs, duties, and tariffs on a wide array of imported goods and to harmonize the excise tax laws and trade practices of its member countries. One of the principal objectives of NAFTA continues to be the promotion of economic neutrality through the elimination of barriers to cross-border trade of goods and services.[38] Custom duties, tariffs, and excise taxes represent trade barriers in the form of indirect taxation. Indirect taxes, such as sales and value added taxes, and direct taxation in the form of personal and corporate income taxes also affect transaction pricing, but NAFTA does not compel the governments of Canada, Mexico, and the United States to harmonize even the most basic application of rules for these types of taxes.[39]

### 3. *National Treatment, Most-Favored Nation Treatment and Taxation in NAFTA*

The trade principle of National Treatment is a fundamental component of NAFTA.[40] Basically, each party to the Free Trade Agreement must accord to nationals of another party treatment no less favorable than it accords, in like circumstances, to its own nationals. Where the National Treatment principle is applied to tax measures, it would prevent a country from providing tax incentives to its own nationals, unless it also provides similar tax benefits to the nationals of the other NAFTA countries. By extrapolation, the National Treatment principle restricts the imposition of any new or additional sales, use, or other consumption taxes on products or services provided by individuals or businesses of a NAFTA Member State, unless such additional tax measures are extended to domestic individuals or enterprises.

The concept of Most-Favored Nation Treatment in NAFTA requires each of the Member States to treat nationals of another party no less favourable than that it accords, in like circumstances, to nationals of any other party or of a non-party. The Most-Favored Nation Treatment prin-

37. *See* Joel Slemrod, *Free-Trade Taxation and Protectionist Taxation*, 2 INT'L TAX & PUB. FIN. 471, 472-480 (1995) (for a discussion of how lack of uniformity in international tax policies undermines the proper functioning of regional trading blocs).
38. Schadewald & Kaye, *supra* note 40, at 355.
39. Indirect taxes (also referred to as consumption taxes) represent an increasingly popular mode of taxation for North American governments. Canada and Mexico collect a significant portion of revenues from a national tax on goods and services. The United States, which does not levy a national-level sales or value-added tax, collects almost 45% or over $700 billion of all tax revenues from state and local taxes.
40. NAFTA, *supra* note 1, art. 2103, para. 2; *see also* Monroy, *supra* note 7, at 741.

ciple has become not only a mainstay of international trade arrangements, it is being increasingly incorporated into international tax treaties that complement regional trading blocs. When extended to tax measures and treaty provisions adopted by Canada, Mexico, or the United States, the principle of Most-Favored Nation Treatment would require these Member States to provide reciprocal tax breaks to the other Member States any time a tax break is accorded to one of the NAFTA parties or to a country that is not a party to the Free Trade Agreement.

The basic NAFTA principles of National Treatment and Most-Favored Nation Treatment do not, for the most part, apply to the domestic tax measures of the Member States.[41] The *prima facie* exclusion of national tax rules from the Free Trade Agreement has important implications. Even though the objectives of NAFTA strive to create a framework of equality in the sense that government measures purport to treat investors, service providers and other parties engaged in cross-border trade in accordance with the principles of National Treatment and Most-Favored Nation Treatment, tax measures are basically not governed by the same standards.[42]

### B. Development of Tax and Trade Policies of NAFTA Parties

The previous section described how the framework established by NAFTA over a decade ago basically shifted the determination and negotiation of international tax measures from a multilateral trade forum to a bilateral tax agreement between two member countries. In so doing, the Free Trade Agreement attributed considerable importance to the particular national tax policies of each Member State. However, the absence of tax integration in NAFTA opened the door to the possibility of incongruent tax measures undermining the efficacy of the liberalized trade rules promoted throughout the Free Trade Agreement. The following section provides some insights into understanding how NAFTA allowed the potentially huge impediment of divergent tax practices to survive the continental movement towards an integrated and comprehensive free trade regime.

#### *1. Prelude to NAFTA*

The decades following World War II saw tremendous expansion in world trade. Ongoing multilateral efforts, such as GATT, encouraged nations to remove impediments to international economic exchanges. As free trade movements in Europe and Asia intensified, Canada and the United States reciprocated with their own liberalized trade initiative in

41. Art. 2103, para. 1 of NAFTA establishes: "Except as set out in this Article, nothing in this Agreement shall apply to taxation measures."

42. Monroy, *supra* note 7, at 741.

1988.[43] Mexico's enthusiastic conversion to the cause of economic liberalism in the late 1980s presented an opportunity for the broadening of the North American trading bloc beyond Canada and the United States of America.

Formal negotiations toward NAFTA began in February 1988, under the auspices of the U.S.-Mexico Framework Agreement. Then U.S. President George Bush and Mexican President Salinas issued a formal statement in June 1990 committing their governments to the negotiation of freer trade between their respective countries. Following this announcement, Canada sought to join in the trade discussions between Mexico and the United States. By February 1991, American, Mexican, and Canadian officials had cleared the way for formal negotiations on a trilateral basis with a view to crafting a broad multilateral free trade agreement. After fourteen months of apparently intense negotiations, the text of NAFTA was initialed in Washington, D.C. on August 12, 1992. On September 18, 1992, then U.S. President Bush notified Congress of his intention to sign NAFTA under the so-called "fast-track" procedures, thereby giving Congress ninety days to review and deliberate the Free Trade Agreement. The formal signing of NAFTA by the leaders of Canada, Mexico, and the United States took place on December 17, 1992. The Agreement was subsequently ratified at different times by the U.S. Senate, the House of Representatives of the United States, the Senate of Mexico, and the House of Commons and Senate of Canada. NAFTA came into force on January 1, 1994.

NAFTA signified a bold attempt to create an integrated North American economy without barriers or distortions to trade in goods or services. More so than any other trade agreement in place at that time, NAFTA combined characteristics of both a trade and an investment agreement into a single instrument. The main purpose of NAFTA was to extend the reductions in trade barriers, customs and tariffs contained in the Canada-U.S. Free Trade Agreement to Mexico. NAFTA, though, went beyond custom and tariff reductions by effectively integrating an investment and services agreement into a conventional trade agreement for the first time.[44]

Mexico's inclusion in NAFTA coincided with the proliferation of trade

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43. The 1988 Canada-U.S. Free Trade Agreement represented the first major step towards the formation of a regional trade bloc within North America.

44. NAFTA has been referred to as "the most comprehensive package of services trade and investment liberalization achieved in an intergovernmental trade agreement to date." Pierre Sauve, *Regional versus Multilateral Approaches to Services and Investment Liberalization: Anything to Worry About? See also* Serge Devos, *The Multilateral Rules and the New Dimension of Regional Integration: Weaknesses, Need and Scope for More Disciplines, in* REGIONALISM AND MULTILATERALISM AFTER THE URUGUAY ROUND. CONVERGENCES, DIVERGENCES AND INTERACTION 728 (Paul Demaret et al. eds., Brussels, European Inter-Univ. Press, 1997), at 442.

liberalization agreements throughout Latin America.[45] The proposal to establish a Free Trade Area of the Americas was announced shortly after NAFTA was concluded.[46] It would be imprecise, though, to refer to the FTAA discussions as an extension of NAFTA because of the difference in the scope of the trade agreements.[47] NAFTA , will undoubtedly influence and inspire the future of trade integration in the Americas in that NAFTA serves as the inevitable point of reference for the Free Trade Agreement of the Americas.[48] However, even the most optimistic observers believe that it would be exponentially more difficult to apply the NAFTA standards for harmonization of trade in goods, services and investments in a manner that would be mutually advantageous to all FTAA parties.[49]

### 2. *United States Tax and Trade Policies*

The United States was party to several tax arrangements in the early 1900s, but it did not enter into its first double taxation treaty until 1932.[50] The 1942 tax convention between Canada and the United States was the first U.S. treaty to apply to investment income and to prescribe mechanisms for administrative cooperation.[51] During the ensuing three decades, the U.S. government was able to ratify only a handful of new treaties, primarily with other developed countries. In 1976, the United States introduced a model bilateral tax convention that would represent the starting point for all of its international tax treaty negotiations.[52] The U.S. Model has been modified several times since its initial presentation

45. The Latin American free trade movement that contributed to the conclusion of NAFTA also led to the ratification of numerous multilateral regional integration agreements; at least fifteen bilateral integration agreements; and a huge number of bilateral investment agreements between Latin American countries, most of which were signed after 1990. *See* ORGANIZATION OF AMERICAN STATES, INVESTMENT AGREEMENTS IN THE WESTERN HEMISPHERE: A COMPENDIUM, *available at* http://www.sice.oas.org/bitse.stm. .
46. *See supra* note 2 and accompanying text.
47. *See* Sidney Weintraub, *The Meaning of NAFTA and its Implications for the FTAA*, 6 NAFTA: L. & BUS. REV. AM. 303, 304 (2000) (wherein it is noted that NAFTA involves much stricter obligations of its three countries than FTAA would expect of its more numerous members).
48. FTAA negotiators are using NAFTA as the model for the prospective free trade agreement for the region with modifications designed to integrate regional concerns. *See* Lopez-Ayllon, *supra* note 11, at 255-56.
49. NAFTA is more comprehensive in both coverage and disciplines than the other trade and investment agreements concluded by Latin American countries. *See* Weintraub, *supra* note 46, at 303-04.
50. Convention and Protocol Between The United States and France Concerning Double Taxation, Apr. 27, 1932, U.S.-Fr., 49 Stat. 3145.
51. For comments regarding early U.S. tax treaty policy, *see* H. David Rosenbloom & Stanley I. Langbein, *United States Tax Treaty Policy: An Overview*, 19 COLUM. J. TRANSNAT' L. 359, 374 (1981).
52. THE DRAFT UNITED STATES MODEL INCOME TAX TREATY was issued by Press Release on May 18, 1976; the official text was released a year later (May 17, 1977) and is *reprinted in* 1 Tax Treaties (CCH) 10,515, para. 201 [hereinafter 1977 U.S. Model]. In addition to being a policy statement, the 1977 U.S. Model is supposedly the starting point for the U.S. Treasury in its treaty negotiations.

with the latest material revision occurring in 1996.[53] As the U.S. Model is designed primarily for use with other industrialized countries, the model convention did not facilitate the conclusion of treaties with developing countries.[54] The United States does not have a comparable model that it could refer to when negotiating a tax treaty with a developing country.

a. Tax Sparing

The issue of "tax sparing" involves an extension of the concept of import neutrality. Tax sparing provisions basically allow the tax benefits offered by a source country to accrue to the taxpayer rather than to the treasury of the residence country. In an attempt to attract foreign investment many developing countries offer special tax holidays or other incentives. Since citizens and residents of the United States are taxed on their worldwide income, most tax incentives would be ineffective unless the U.S. Treasury either exempted the foreign income or provided a compensatory credit. The slow progress of U.S. tax treaty negotiations with developing countries, in comparison to Canada and various European nations has been attributed primarily to the refusal of the United States government to accept the principle of tax sparing.[55]

U.S. government policy on the issue of tax sparing has been plagued by differences in opinion between the country's executive and legislative branches dating as far back as the late 1950s.[56] The executive branch, which seems inclined towards improving foreign relations and prospects for international trade, accepted tax sparing provisions in several treaties, but it was rebuffed on every occasion by the legislative branch for reve-

53. *See* UNITED STATES MODEL INCOME TAX CONVENTION of September 20, 1996, *in* INTERNATIONAL TAX TREATIES OF ALL NATIONS 481 (Diamond & Diamond eds., 1996) [hereinafter 1996 U.S. Model].

54. The U.S. Model treaty is renowned for its emphasis on taxation of multinational income by the taxpayer's residence country. Most developing countries are capital-importers and, accordingly, they tend to be opposed to residence country taxation and favour source country taxation. This tension is highlighted by the U.S. Model treatment of interest, royalties and dividends, which provides for exclusive residence country taxation of interest and royalties received by U.S. persons from foreign sources through the elimination of any withholding tax on such payments, and stipulates a low withholding tax rate for dividends thereby increasing taxation of dividends by the residence country. 1996 U.S. Model, *supra* note 53, arts. 10-12.

55. *See* Howard M. Liebman, *A Formula for Tax-Sparing Credits in U.S. Tax Treaties with Developing Countries*, 72 AM. J. INT'L L. 296, 302 (1978).

56. The Convention for the Avoidance of Double Taxation with respect to Income Between Pakistan and the United States, *reprinted in* 4 Tax Treaties (CCH) 38,501 (signed July 1, 1957), was indicative of the considerable difficulties encountered by U.S. tax authorities in the early days of treaty negotiations with developing countries. The Eisenhower administration concluded a treaty with Pakistan in 1957 that contained a tax sparing provision in favor of Pakistan. The Senate approved the Convention, but subject to a reservation with respect to the tax sparing provision. S. Exec. Rep. No.1, 85th Cong. 2d Sess. 3 (1958). During the Senate ratification of the Pakistan treaty, the Foreign Relations Committee expressed hostility to the concept of tax sparing and indicated that the treaty should not receive the requisite support if the tax sparing provision remained. Pakistan unilaterally repealed its tax incentive legislation thereby making the provision moot. Rosenbloom & Langbein, *supra* note 51, at 379-80.

nue and tax policy reasons.[57] Thus, even though Canada and numerous other developed countries have implemented tax-sparing credits in tax treaties with developing countries in pursuance of international equity principles, the United States steadfastly remains committed to its current policy of resisting tax-sparing concessions.[58]

b. Tax Treaties as an Adjunct to Free Trade Agreements

Notwithstanding its opposition to the concept of tax sparing, the United States has been able to recently expand its tax treaty network to include several important developing countries.[59] Many of these treaties were concluded in the past ten years giving credence to the claim that the U.S. Treasury Department shifted its interests in the early 1990s towards concluding income tax treaties with emerging economies for a mixture of political and economic reasons.[60] During this time the United States Treasury targeted Latin America as a high priority for future tax treaty

57. Over the twenty-year period following the U.S.-Pakistan treaty flop of 1958, seven other developing countries also signed a bilateral tax agreement with the United States only to have the Senate reject the treaty, or so alter the agreement as to make the arrangement unacceptable to the treaty partner. The Kennedy and Johnson administrations abandoned the tax sparing principle, but agreed to extend to developing countries a credit similar to the statutory investment tax credit that was enacted for American taxpayers in 1962. However, this approach was eventually deemed unacceptable by the Foreign Relations Committee. Rosenbloom & Langbein, *supra* note 51, at 382-87.

58. *See* Claudia MacLachlan, *Trade Spike Spurs Tax Treaty Talks*, NAT'L L.J., Sept. 2, 1996, at A1, A17 (reporting that "the United States is not about to relent on its opposition to Brazil's negotiation demand for 'tax sparing.'"); *see also* Richard Mitchell, *United States-Brazil Bilateral Income Tax Treaty Negotiations*, 21 HASTINGS INT'L & COMP. L. REV. 209, 230-231 (1997) (noting that U.S. opposition to tax sparing has gone beyond ideological concerns and that the U.S. position is now entrenched against tax sparing for practical purposes): "[I]n reality it is unlikely that the United States will ever relent. Granting tax sparing to Brazil will set an undesired precedent for future negotiations with other developing countries; moreover, other treaties already in effect promise to grant tax sparing in the event that any other country should get tax sparing in a U.S. tax treaty."

59. The United States now has bilateral tax conventions with the following underdeveloped countries: Brazil, China, India, Mexico, Khazakstan, Ukraine, Thailand, and Russia.

60. The United States has demonstrated a greater willingness to deviate from the U.S. Model to address the particular concerns of the developing country, provided the treaty partner offers potential trade and investment opportunities to U.S. nationals. *See* TAX EXECUTIVES INSTITUTE, COMMENTS ON U.S. MODEL INCOME TAX TREATY, 45 THE TAX EXECUTIVE 66, 67 (1993); and Paul D. Reese, *United States Tax Treaty Policy Toward Developing Countries: The China Example*, 35 UCLA L. REV. 369, 373 (1987) (where political and strategic factors are presented as major influences in the negotiation of the 1986 U.S.-China Convention). U.S. treaty policy as embodied by its tax conventions with the two most populous countries in the world can be reviewed in: Convention Between the United States of America and the Government of the Peoples Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, 1 Tax Treaties (CCH), ¶ 2137; and Convention Between the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, 2 Tax Treaties (CCH), ¶ 4203.5.

negotiations as an adjunct to FTAA negotiations.[61] In 2000, the United States launched a major initiative to bolster trade and strengthen relations with Carribbean and developing nations in Africa.[62]

The U.S.-Mexico Convention represented a theoretical change in the direction of U.S. trade and tax policy. By conceding to Mexico relatively higher levels of source-based taxation, the United States moved towards using international tax policies as a mechanism to assist U.S. businesses to compete in a liberalized trade environment. The U.S. Treasury and Foreign Trade Departments have indicated that the 1992 U.S.-Mexico Convention provides the best example of U.S. tax treaty policy as a conjunct to its free trade negotiations.[63] The United States now appears prepared to extend the tax and trade benefits enjoyed by Mexico to other countries in the Americas. It is interesting to note that current U.S. trade policy is focused on the potential impact of trade and treaty rules on the future of electronic commerce.[64] However, the United States has not expressed any clear indication that it seeks to integrate tax rules into NAFTA or the FTAA to govern global commerce.

### 3. *Canada's Willingness to Accommodate*

Canada has developed an extensive network of bilateral tax treaties.[65] Canada's first comprehensive double taxation treaty was concluded in 1942 with the United States.[66] The current Canada-U.S. Convention governs more trade and investment income than any other bilateral tax

61. Joseph H. Guttentag, *An Overview of International Tax Issues*, 50 U. MIAMI L. REV. 445, 450 (1996).
62. On May 18, 2000, the United States enacted the TRADE AND DEVELOPMENT ACT OF 2000, Pub. L. No. 106-200, 114 Stat. 251 (2000) (a legislative package that contained the Africa Growth and Opportunity Act and the U.S.-Caribbean Basin Trade Partnership Act).
63. *See* Mitchell, *supra* note 58, at 239 (where it is claimed that treaties largely mirroring the U.S.-Mexico tax treaty will form the basis of a large, free trade agreement for the region).
64. U.S. trade policy is committed to using the FTAA to deepen "our region's understanding of the implications and benefits of electronic commerce for our societies . . . In accordance with the President's Global Electronic Commerce initiative, the Administration seeks to preserve electronic transmissions over the Internet as duty-free . . . We also have begun a longer-term work program, whose goals include ensuring that our trading partners avoid measures that unduly restrict development of electronic commerce; ensuring that WTO rules do not discriminate against new technologies and methods of trade . . . [and] take maximum advantage of electronic commerce." Barshefsky, *supra* note 17.
65. Canada is currently a party to over eighty bilateral tax conventions. *See* Canada-Department of Foreign Affairs and International Trade Web site for a list of signed treaties and to determine the status of treaties under negotiation, http://www.dfait-maeci.gc.ca/menu-en.asp (last visited Aug. 25, 2003).
66. Canada's first international taxation treaty, signed in 1928, was also with the United States of America, but it applied only to the taxation of shipping profits. Canada subsequently entered into several tax conventions with other trading partners; however, all of these agreements were also restricted to the taxation of multi-jurisdictional shipping and transportation income.

treaty in the world.[67] Canada's status as a capital-importer vis-à-vis the United States, and a capital-exporter to most other countries in the world, has influenced the development of Canada's tax treaties.[68] Canada's success in concluding treaties with developing countries could be attributed to the government's willingness to recognize and accommodate the interests of developing countries in its tax treaty negotiations. For instance, one popular accommodation device that is found in most of Canada's tax treaties with developing countries is the tax sparing provision.[69]

Canada has, in many of its treaty conventions, adopted a variation of the Most-Favored Nation Treatment principle common to trade agreements.[70] Theoretically, when negotiating a tax treaty with another developed country, Canada will generally accord the taxpayers of the developed country the same treatment that it accords investors and exporters from other developed countries. On the other hand, if Canada is negotiating a tax treaty with a developing country, Canada will normally grant and accept the fairest and best deal that the developing country can afford based on the developing country's treatment of taxpayers from other developed countries. In other words, Canadian negotiators attempt to secure for Canadian taxpayers treatment from the developing country as favourable as the best treatment accorded to investors and exporters from other developed nations. In 1991, Canada became the first nation to conclude a comprehensive tax convention with Mexico.[71] Canada's Most-Favored Nation international tax policy has been a significant factor in the development of its expansive treaty network.

67. The 1942 Canada-U.S. Convention for the Prevention of Double Taxation has been revised numerous times since its ratification. The 1980 Canada-U.S. Income Tax Convention, signed at Washington, D.C. on September 26, 1980, amended by a First Protocol in 1983; amended by a Second Protocol in 1984. Income Tax Convention, Sept. 26, 1980, U.S.-Can., art. 30, 1980 U.S.T. 154 [hereinafter Canada-U.S. Convention].

68. It is claimed that Canada must always be conscious of how treaty negotiations with other countries will impact on Canada's ongoing treaty negotiations with its most important treaty partner, the United States. *See* Alexander J. Easson, *The Evolution of Canada's Tax Treaty Policy Since the Royal Commission on Taxation*, 26 OSGOODE HALL L.J. 495, 510 (1988).

69. *See* CANADA'S TAX TREATIES 1 (A. McKie ed., 1999) [hereinafter CANADA'S TAX TREATIES].

70. Canada formulated its tax treaty policy of Most Favoured Nation Treatment in the early 1970s and apparently the policy has not materially changed since then. *Id.*

71. Actually, Canada entered into treaty negotiations with Mexico in the early 1970s, but the two countries were unable to finalize an agreement at that time due to Mexico's strong adherence to the principle of exclusive taxation of international income at source. *See id.* at 667. THE CONVENTION FOR THE AVOIDANCE OF DOUBLE TAXATION ON INCOME BETWEEN CANADA AND THE UNITED MEXICAN STATES was signed on April 8, 1991, Can.-Mex. (hereinafter Canada-Mexico Convention). The Canada-Mexico Convention was proclaimed into force on May 11, 1992, with many of its provisions made retroactive to January 1, 1992.

#### 4. *Mexico as the Gateway to the Americas*

*"Poor Mexico, so far from God and so close to the United States."*[72]

Mexico's trade relations with the United States have always been a pervasive feature of Mexican foreign policy. In the decades following the end of World War II, Mexico's trade policies focused on reducing economic dependence and vulnerability to the United States.[73] For many years, Mexico and most of Latin America espoused the protectionist policy of "economic development from within."[74] The Mexican government would subsidize the establishment of domestic industries and protect them against foreign competition. Mexico's closed economy was based on import substitution, which subjected foreign investors and industries to stringent restrictions and requirements to employ large amounts of inputs produced in Mexico.[75]

While Mexico's policy of development from within fostered the growth of a domestic industrial sector, Mexican production was generally not competitive in world markets. The collapse and near bankruptcy of Mexico's economy in the early 1980s necessitated dramatic structural changes in economic policy. Mexico's formal abandonment in 1982 of its longstanding policy of development from within set the stage for the country to open its markets to international trade.[76] By 1986 Mexico had joined the General Agreement on Tariffs and Trade (GATT). Within a few years after its acceptance of GATT, Mexico had dismantled its tariff regime and enacted tax reforms designed to attract foreign investment to the country.[77] The taxation of international income eventually became a

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72. SIDNEY WEINTRAUB, MEXICAN TRADE POLICY AND THE NORTH AMERICAN COMMUNITY, vii (1988).
73. In 1990, the United States was the destination of almost 70% of Mexico's overall exports and over 80% of Mexico's manufactured goods exports, but due to the relatively low incomes of its people, Mexico was unable to provide the reciprocal market to U.S. exports.
74. This policy was initially formulated by the Economic Commission for Latin America and was based on the premise that the path to development was through the establishment of a manufacturing base. *See* J.L. Love, *Raul Prebish and the Origins of the Doctrine of Unequal Exchange*, 15 LATIN AM. RES. REV. 45 (1980).
75. Lopez-Ayllon, *supra* note 11, at 241.
76. The ascendancy of Miguel de la Madrid to the Presidency in 1982 coincided with Mexico's declaration that international trade represented the new path to industrialization and growth. Mexico's trade balance went from deficit in 1981 to surplus in 1982 and following years. Mexico's increase in exports was largely the result of greater sales of oil to foreigners, which by 1986 had climbed to almost 78% of total exports. When the price of oil collapsed in 1986 the Mexican economy was once again perched on the edge of total collapse. By then Mexico's external debt had reached epic proportions and the value of its currency plummeted rapidly, which in turn fuelled annual inflation to three-digit levels. Under President Miguel de la Madrid's leadership, Mexico was able to reschedule interest payments on its foreign debt. The World Bank subsequently extended hundreds of millions of dollars of loans to Mexico on the condition Mexico lower tariffs and undertake other import liberalization measures.
77. Following the election of Carlos Saunas de Gortari as President in 1988, the Mexican government undertook tax reforms that gradually reduced corporate income tax rates and the rates of withholding tax payable by non-residents on interest

primary component of Mexican foreign trade policy.[78]

Mexico's decision to pursue free trade negotiations with Canada and the United States required substantial changes in Mexico's tax and legal systems.[79] Mexico and other relatively poor countries persistently refused to enter into bilateral tax agreements with developed countries unless provision would be made to ensure reciprocity of revenue claims in connection with multinational business and investment income.[80] As part of the NAFTA process, Mexico had to enter into bilateral tax treaties with each of the other Member States. The Canada-Mexico Convention that was signed during the NAFTA negotiations constituted the first comprehensive tax treaty concluded by Mexico.[81] Mexico had historically supported the principle of assigning exclusive taxation of international income to the source country.[82] The Canada-Mexico Convention, a hybrid of the texts of the OECD Model and the UN Model, represented a dramatic departure on Mexico's part from its historical territorial taxation policies.[83]

In 1992, Mexico and the United States concluded a bilateral tax treaty that, from Mexico's perspective, departed relatively far from the country's long-standing policy of primary source taxation.[84] Mexico's decision to conclude a free trade agreement with the United States required the abandonment of any notion of special accommodation within NAFTA or the associated bilateral tax treaties. Mexico could not, on one hand,

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income and royalty payments for technical assistance to levels comparable to those in Canada and the United States.

78. *See* L. Rubio, *The Rationale for NAFTA: Mexico's New 'Outward-Looking' Strategy*, 27 Bus. Econ. 12 (Apr. 1992) (where it is suggested that Mexico's traditional support of the principle of exclusive taxation at source coupled with its new, lower income tax rates reduced the incidence of double taxation while permitting the Mexican treasury to receive the revenue benefits of increased foreign investment).
79. "It should be noted that the cost Mexico had to pay to prepare for and adapt to the new circumstances, including the negotiation and implementation of NAFTA, was extremely significant. Without going into details, between 1982 and 1995, most of Mexico's internal legal system was modified, particularly as regards economic, trade, and financial issues. Thus, 164 of the 204 federal statutes (except for Federal District legislation) in force in 1995 were new or substantially modified. In other words, Mexico had to modify nearly eighty percent of its domestic legal system as a result of the new orientation of the economic growth model and trade liberalization." Lopez-Ayllon, *supra* note 11, at 243.
80. *See* Sonia Zapata, *The Latin American Approach to the Concept of Permanent Establishment in Tax Treaties with Developed Countries*, 52 Bull. For Int'l Fisc. Doc. 252, 253 (1998).
81. Canada-Mexico Convention, *supra* note 67.
82. Like many other Latin American countries, Mexico was reluctant to reduce the level of source country taxation and, therefore, had avoided concluding any tax treaties prior to NAFTA.
83. It was necessary that Mexico abandon the territorial principle of taxation that it historically supported because Canada and the United States were not prepared to abandon their entire treaty network, which would be necessary if Canada and the United States were to accept the source taxation principles introduced in the 1943 Mexico Model.
84. Tax Convention Between the United States of America and the United Mexican States (Sept. 18, 1992) U.S.-Mex., S. Treaty Doc. No. 103-7 (1992), *reprinted in* 2 Tax Treaties (CCH) 5903 [hereinafter U.S.-Mexico Convention].

plead with its NAFTA partners for special treatment in bilateral treaty negotiations because of its status as a developing country and, on the other hand, demand more or less equal status and participation in the comprehensive Free Trade Agreement. By signing NAFTA and concluding bilateral tax conventions with both Canada and the United States, Mexico was able to establish a system that allowed its people to participate in the acquiring of wealth created by free trade.[85] In so doing, Mexico was able to assume a leadership role in the Latin American movement towards trade integration throughout the Americas.[86]

## III. INTERACTION OF INCOME TAX LAWS AND NAFTA RULES

### A. Domestic Tax Treatment of Multinational Income

#### 1. *Taxation of Foreign Income of Nationals*

The domestic income tax laws of the parties to NAFTA are predicated on the global taxation of the income of their own nationals. The United States taxes all U.S. persons on their worldwide incomes.[87] Canada and Mexico similarly tax the world incomes of their respective resident individuals, trusts and business entities.[88] Resident taxpayers are generally required to include all income derived from domestic and foreign sources when calculating taxable income for a given taxation period. Domestic taxpayers in the United States, Canada, and Mexico are generally subject to income taxation on a net basis. Residents are required to report income from all sources for the taxation period in question, but the national treasury permits deductions for the purpose of determining taxable income subject to domestic taxation.

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85. *See* Monroy, *supra* note 7, at 740.

86. Moreover, Mexico has successfully used material parts of NAFTA as a model in its trade negotiations with other Latin American countries. *See* Lopez-Ayllon, *supra* note 11, at 254. Buoyed by Mexico's successes, Chile signed a free trade agreement with Canada and Mexico that essentially followed the trade aspects of the NAFTA model.

87. United States persons are taxed on their global income. Internal Revenue Code of 1986, as amended [hereinafter I.R.C.], § 61 (2002). Citizens, resident individuals and domestic corporations are among the classes of taxpayers included in the statutory definition of a "United States person." I.R.C. 7701(a)(30) (2002). Whether an individual is considered a resident of the United States for tax purposes will generally depend on the person's legal status, personal circumstances, and whether the resident has a tax home in a foreign country and/or the degree of the individual's physical presence in the United States. Unlike its NAFTA counterparts, the United States also taxes individuals on the basis of citizenship. *See* I.R.C.§ 865 and Treas. Reg. §1.1-1.(c), , as amended. .

88. Canada taxes the global income of its resident individuals, trusts and corporations. Income Tax Act, R.S.C., ch. 1 (1985) (5th Supp.), as amended [hereinafter I.T.A.], § 2. Mexico also imposes an income tax based on the residence of the taxpayer with residents subject to tax on a worldwide basis. The Mexican tax system is comprised of a number of taxes imposed principally at the federal level; there are no state or city income taxes in Mexico. *See* Monroy, *supra* note 7, at 742, 747 (indicating that Mexico's taxing powers arise from the obligation of citizens to make contributions to satisfy public expenses established in article 31(IV) of "Constitucion Politica de los Estados Unidos Mexicanos").

A corporation is *prima facie* subject to taxation as a national of the jurisdiction where the entity was incorporated.[89] While many nations define a resident corporation, for tax purposes, as a company incorporated in the state, a significant number of countries have also enacted laws that purport to deem a corporation to be a resident of the country if the company's place of central management is located domestically or, more rarely, if the corporation's principal economic activities are conducted locally.[90] Corporate residence has an intentionally wide scope under the domestic tax laws of each of Canada, Mexico, and the United States due to the concerns of national tax authorities regarding the potential for manipulation of corporate residence rules for tax avoidance purposes. The malleable nature of global business enterprises, particularly those engaged in e-commerce and other digital activities, are increasingly wreaking havoc with the application of traditional source and residence rules. For instance, e-commerce enterprises based in the United States have had to extrapolate from existing legislation, Public Law 86-272, in order to claim exemption from income taxation in states where the entity does not have a substantial presence.[91]

### 2. *Taxation of Domestic Income of Foreign Nationals*

Non-residents are often subject to taxation in the country where they earn income.[92] Investment income has its source in the jurisdiction where the payer of the interest, royalty or dividend is situated. Business income is generally taxed on the basis of the connection between the commercial enterprise and the jurisdiction where the income is derived. Foreign businesses are subject to the national tax laws of all nations where they complete sales, unless the foreign national can demonstrate that it did not meet the minimum nexus for taxation in the source country.

The United States' threshold for determining whether the business profits of a non-resident fall within the country's tax jurisdiction involves an analysis of the nature of the activities of the foreign national. .[93] Non-

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89. *See, e.g.*, I.R.C., *supra* note 87, § 7701(a)(4) (which defines a domestic corporation as an entity that was "created or organized in the United States or under the law of the United States or of any State").
90. JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME ¶ 4.1, at 3 (1996).
91. *See generally* KARL FRIEDEN, CYBERTAXATION: THE TAXATION OF E-COMMERCE 334-41 (2000). Basically, Public Law 86-272 is a special federal statute that prevents states from imposing income taxes on sellers of physical goods whose only contact with the state is the solicitation of orders. *See* Uniform Division of Income Tax Purposes Act, Pub. L. No. 82-272, 73 Stat. 555 (1959). Even though Public Law 86-272 was enacted by Congress to protect vendors of tangible personal property from having to comply with a wide array of state income tax rules, it is expected that the legislation can be utilized by e-commerce businesses operating in the United States.
92. For instance, Canada's domestic tax rules apply to any non-resident earning office, employment or other income within Canada. I.T.A., *supra* note 88, § 3.
93. Tax authorities in the United States and Canada utilize a similar minimum nexus standard for determining jurisdiction to tax the multinational business profits of non-residents. See Forgione, *supra* note 10, at 734-45. The test for determination

resident corporations and individuals are subject to income taxation in the United States on all income effectively connected with a U.S. trade or business.[94] Generally, in order for a foreign entity to be treated for tax purposes as being engaged in a U.S. trade or business, the business activities must be of a regular, continuous, and substantial nature.[95] An occasional or isolated sale transaction will not in itself cause a foreign vendor to be liable for income taxation in the United States.[96] Where a foreign resident is subject to the tax jurisdiction of the United States on the basis that it is engaged in a trade or business within the United States, then all effectively-connected U.S. source income of the non-resident will be taxed at the same rates and in the same manner as the income of a domestic U.S. taxpayer.[97]

In Canada, a foreign company that is found to be "carrying on business in Canada" will be subject to Canadian income tax.[98] The determination of whether the foreign national is carrying on business in Canada will depend on the ordinary meaning of the words as applied to the context of the non-resident's business activities in Canada. Canada's tax rules could apply to any activity in which a person solicits orders or offers anything

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of the appropriate nexus for Mexican income taxation is not always clear. Mexican tax law utilizes the concept of permanent establishment in its domestic legislation, but provides for a number of situations where a non-resident without a permanent establishment will nonetheless be subject to income taxation in Mexico based on a wide array of deemed sources of income. Title V of *Ley Del Impuesto Sobre La Renta* covers most common types of business and non-business related income. Monroy, *supra* note 7, at 747.

94. The tax liability of non-resident individuals is determined under Internal Revenue Code, §§ 871 to 877, while the U.S. tax liability for foreign corporations is set out in Internal Revenue Code, §§ 881 to 884. I.R.C., *supra* note 87, §§ 871-77, 881-84.

95. The Internal Revenue Code does not contain a helpful definition of what would constitute a trade or business. Whether a business is deemed to be engaged in a trade or business in the U.S. will depend on the facts of each case. The determination of what activities would be sufficient to constitute a U.S. trade or business has been developed by various court decisions and revenue rulings over the years. The principle of regular, substantive and continuous activity as creating a nexus for income taxation is derived from the leading case of Spermacet Whaling & Shipping Co. v. Commissioner, 30 T.C. 618, 634 (1958). Substantial U.S. sales by a nonresident may not in itself create a U.S. tax liability. *See* Commissioner v. Piedras Negras Broadcasting Co., 127 F.2d 260 (5th Cir. 1942).

96. OFFICE OF TAX POLICY, U.S. DEPARTMENT OF THE TREASURY, SELECTED TAX POLICY IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE, 7.2.3.1. (1996), *available at* http://www.ustreas.gov/offices/tax-policy/library/internet.pdf (where the U.S. Treasury declares: "[T]o the extent that the activities of a person engaged in electronic commerce are equivalent to the mere solicitation of orders from U.S. customers, without any other U.S. activity, it may not be appropriate to treat such activities as a U.S. trade or business.").

97. U.S. tax law provides that where income is "effectively connected" with a trade or business in the United States, such income will be subject to U.S. federal income tax. *See* I.R.C., *supra* note 87, §§ 864(b)-(c), 882(a)(1) (which applies to foreign corporations, allows the profits of the foreign enterprise that are attributed to the United States to be calculated like those of a U.S. resident, that is, subject to U.S. taxation on a net basis).

98. A non-resident enterprise will be subject to income taxation in Canada if it is determined that the foreign entity is carrying on business within Canada. I.T.A., §§ 2(3)(b), 253(b).

for sale in Canada through an agent or servant, whether the contract or transaction is completed inside or outside Canada.[99]

The nexus for income taxation established under the domestic tax laws of the United States and Canada is materially altered by the provisions found in the applicable tax treaties. It is possible under most bilateral tax conventions for a foreign business, particularly an e-commerce enterprise, to conclude regular, continuous and substantial sales in a NAFTA country without being subject to taxation in that source country. Most significantly, the treatment accorded to foreign businesses under bilateral tax treaties bypasses the criteria used to determine minimum business contact under the national tax rules of each of the NAFTA Member States.

### 3. *Unilateral Application of Foreign Tax Credit Rules*

Since most nations tax residents on worldwide income and also tax non-residents on domestic income earned within the country's borders, it is easy to envision instances of double taxation of the same income. Double taxation may arise whenever a country asserts jurisdiction to tax the foreign income of its residents or citizens and the same income has been subject to tax in the foreign country. Canada, Mexico, and the United States have adopted rules in their domestic tax regimes that address this potentially huge obstacle to international trade.[100] The domestic tax rules of each of these countries provide unilateral relief from double taxation to the residents of the country by granting a tax credit for foreign taxes paid.[101] The foreign tax credit regime generally applies only to income tax payments made to foreign treasuries.[102] Foreign tax credit rules effectively permit resident taxpayers to offset the amount of foreign income taxes paid against the amount of domestic income taxes that

99. The meaning of the phrase "carrying on business" has been explored infrequently by Canadian courts, but it appears clear that the non-resident must engage in activities beyond a mere invitation to treat or sell. *See* Sudden Valley Inc. v. The Queen, [1976] C.T.C. 775 (F.C.A.).

100. Tax laws in the United States and Canada generally allow the taxpayer to claim a credit for foreign taxes paid on foreign business income with the amount of the credit calculated on a country-by-country basis up to the amount of domestic tax that would otherwise be payable on the foreign source income. I.R.C., §§ 901-908. Canada's foreign tax credit rules are contained in I.T.A., *supra* note 86, §§ 90-95, 126. In Mexico, the foreign tax credit provisions were extensively revised in 1998 and now allow for direct and indirect credits, establish a ten-year carry forward term and set forth useful guidelines to avoid double taxation due to overlapping residence or citizenship rules established by *Ley Del Impuesto Sobre La Renta*. Monroy, *supra* note 7, at 747.

101. Some countries use an exemption system as an alternative to the tax credit mechanisms popular in North America. Under an exemption system, the foreign source income earned by the resident taxpayer is basically exempted from the resident's tax base. The exemption or territorial system of providing relief from double taxation may be found in limited circumstances in Canadian, Mexican, and U.S. tax laws, such as in connection with exempt dividends of certain foreign affiliates.

102. The relief from double taxation provided by the foreign tax credit rules does not usually extend to sales, use, goods and services, social security, value-added and other non-income taxes.

would otherwise be subject to basket or source limitations.[103] Domestic foreign tax credit rules are structured so that taxes paid to foreign governments cannot be applied to offset the amount of taxes due to the taxpayer's country of residence on domestic source income.

## B. Taxation of Income under Bilateral Tax Treaties

### 1. *Significance of Tax Conventions Generally*

A nation's tax treatment of the multinational income of its residents is modified by the rules and principles established by the country's tax treaties. Bilateral tax conventions present a mechanism for two countries to agree upon ways of eliminating or reducing double taxation of multinational income, promoting information exchanges between tax authorities and ameliorating any discriminatory tax treatment of foreign businesses. The elimination of double taxation for individuals and enterprises having income-earning operations in more than one country is the most frequently cited rationale for entering into an international tax treaty.[104] In fact, elimination of double taxation is no longer the primary objective of modern tax treaties because the domestic tax laws of most countries incorporate relieving provisions to deal with the potential problem of double taxation.[105]

It is a reality of international taxation that treaty partners are motivated more by their own fiscal interests than concern over the plight of the taxpayer.[106] Taxation treaties usually assign one country the primary

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103. In Canada, foreign income tax payments can be credited against Canadian income taxes payable, but the foreign tax credit amount is effectively limited to the amount of Canadian tax otherwise payable on each source of foreign source income. U.S. tax law uses a basket system for different sources of foreign income. Under the basket system, U.S. resident taxpayers claiming a foreign tax credit must allocate their foreign source income according to statutory categories of income that are defined by specific criteria. Unused credits for foreign taxes paid may typically be carried forward to future years; income that does not fall within any of the defined categories falls into a general limitation basket. I.R.C., § 904(d)(1)(I). Congress apparently designed the basket system in order to stop domestic taxpayer abuse of the foreign tax credit rules. *See* Charles H. Gustafson & Richard Crawford Pugh, Taxation of International Transactions ¶ 8067 (4th ed. 1995).

104. *See* Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 Tax L. Rev. 131 (2001) (where it is noted that the avoidance of double taxation was historically cited as the rationale for entering into tax conventions, but suggesting that bilateral tax treaties may actually impose barriers to international commerce).

105. Other plausible rationales for entering into bilateral tax treaties are the prevention of tax avoidance and evasion; to reduce impediments to trade and investment; provision of assurances of stability for foreign trade and investment; and promotion of fiscal incentives for private investment in developing countries. *See* U.N. Department of International Economics & Social Affairs, U.N. Model Double Taxation Convention Between Developed and Developing Countries 1 (1980) [hereinafter U.N. Model].

106. *See* Forgione, *supra* note 10, at 752-53 (where I argue in greater detail that due to countries having unilaterally taken steps to protect their residents from double taxation of foreign source income, the primary motivating force for the conclusion of new tax treaties is often the fiscal demands of taxing nations.).

or exclusive right to tax certain types of income. Although tax treaties do not levy any new taxes, they provide rules that accommodate competing tax claims. Since national tax laws effectively resolve many instances of international double taxation, the motivating force behind entering into a tax treaty in the twenty-first century appears to focus on the division of tax claims. Where a bilateral tax treaty does not exist, a country will generally have the primary and unrestricted right to impose tax on income derived from sources within the country. The country in which the taxpayer is resident will typically provide relief from double taxation either through the credit or exemption method.[107]

The existence of a tax treaty or agreement between two countries significantly changes the status quo. Treaty rules provide tie-breakers in instances where overlapping substantive tax claims exist. One of the contracting states is bound to withdraw all or part of its tax claim, usually by limiting the application of its domestic source rules. Bilateral tax treaties establish an independent mechanism for allocating taxing jurisdiction and, accordingly, a means of dividing aggregate available tax revenues between two contracting states. Treaty rules that allocate tax jurisdiction over multinational income are likely to have little or no impact on net revenue flows between nations with relatively similar trading power. However, fiscal imbalances arise when bilateral treaties developed for countries with relatively equal trading strength are applied to situations involving significant disparities between the contracting nations. When prevailing tax treaty norms are adapted to unequal economic exchanges, the taxpayer's country of residence will scoop a greater share of tax revenues compared to the pre-treaty situation. The prevalence of treaty rules that, in effect, penalize capital-importing and other economically disadvantaged countries has been the most significant obstacle to the conclusion of tax treaties between developed and developing countries.[108]

Bilateral tax treaties have anomalous practical implications. Since many of the world's large multinational enterprises have their head office or base in an industrialized country, the current network of bilateral tax treaties distorts the allocation of income tax revenues in favor of capital-exporting industrialized countries. Tax treaty rules basically require capital-importing nations (usually developing countries) to forego substantial amounts of revenue in favor of capital-exporting nations (typically devel-

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107. The United States, Canada, and Mexico rely primarily on foreign tax credit rules for relief from double taxation while other nations provide relief by exempting the foreign source income of their own residents from domestic tax. The widespread use of such unilateral tax-relieving provisions effectively reduces the prospect of double taxation in the absence of a tax treaty. Double taxation may still arise in cases where countries have overlapping residence or source jurisdiction rules. Countries, such as the United States, that purport to tax individuals or corporations on grounds other than residence (e.g., citizenship) use tax conventions to address particular concerns about double taxation.

108. *See* Stanley S. Surrey, *United Nations Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries*, 19 HARV. INT'L L.J. 1, 11 (1978).

oped countries), despite the legitimate claim of the source country to these revenues. The current treaty network, therefore, has the odd effect of promoting revenue flows from the treasuries of poor countries to the treasuries of rich nations. To make matters worse, the growth of electronic commerce further encourages this process of reverse foreign aid.[109] The continued inequitable distribution of tax claims will undermine multilateral efforts to promote worldwide acceptance of international trade and taxation norms.

In addition to contributing to odd imbalances of tax revenues between disparate nations, bilateral tax treaties also open the door for complex tax avoidance schemes and treaty shopping.[110] Technological developments facilitate the maneuvrability of residence to take advantage of treaty rules. It is now possible for multinational enterprises to carry on business activities in multiple jurisdictions with numerous offices and without any clear central place of management. These stateless entities can engage in substantial amounts of international trade without having to establish a fixed base in any particular country. Tax authorities are becoming increasingly concerned that mobile commercial entities are being designed to exploit traditional treaty definitions that place great importance on the location of a permanent establishment and corporate residence. It has been argued that efforts to determine the locations and residence of these global commercial enterprises are "largely an effort to put flesh into fiction, to find economic and political substance in a world occupied by legal niceties."[111]

### 2. *Historical Development of Model Taxation Treaties*

The expansion in the number and scope of tax treaties in recent years can be traced to the increased sophistication and refinement of model conventions aimed at the prevention of double taxation. The origin of most model treaties can be traced to a multilateral tax agreement endorsed by the League of Nations in 1928.[112] The original model treaty, really a set of rules that came to be known as the 1920's compromise, established a balance between the revenue interests of the source and

109. *See* Forgione, *supra* note 10, at 759-62 (where it is noted that e-commerce enterprises are far less dependent on the presence of a permanent establishment or tangible fixed base within the market country.)

110. *See* Allan R. Lanthier, *The Concept of Residence*, *in* IFA SPECIAL SEMINAR ON CANADIAN TAX TREATIES: POLICY AND PRACTICE, 13:1-21 (Brian Arnold & Jacques Sasseville eds., 2001).

111. Michael J. Graetz, *The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 320 (2001).

112. 1928 BILATERAL CONVENTION FOR THE PREVENTION OF DOUBLE TAXATION IN THE SPECIAL MATTER OF DIRECT TAXES. For an historical overview of early international tax and treaty developments, *see* ARVID A. SKAAR, PERMANENT ESTABLISHMENT: EROSION OF A TAX TREATY PRINCIPLE 78, 82-85 (1991); *see* Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021 (1997), at 1041-1108.

residence countries.[113] The compromise referred to an arrangement that allowed the source country to tax profits derived from certain business operations of a foreign enterprise within the country as well as to tax part of any rents, royalties, interest or dividends paid to a foreign resident.[114]

Many nations, especially the emerging countries of Latin America, were opposed to the 1920s compromise eschewed by the League of Nations almost from its inception.[115] In 1943, the Fiscal Committee of the League of Nations, including representatives from Latin America, the United States, and Canada, met in Mexico City with the intention of drafting a tax convention that would address the concerns of developing countries. Following contested discussion, the Committee adopted a model tax convention, often referred to as the "Mexico Draft," that granted the source country considerable jurisdiction to tax income generated by foreign residents within the host country.[116] The Mexico Draft has been called "the first attempt by the developing countries to write a model treaty reflecting their particular problems."[117]

Industrialized countries were not prepared to accept the possible revenue losses associated with the expanded source country taxation rules set out in the Mexico Draft. When the Fiscal Committee of the League of Nations met again in 1946, this time in London, the Committee sought to obtain the endorsement of the international community to residence taxation on the grounds of administrative convenience and the promotion of the principle of capital-export neutrality. Accordingly, the League of Nations adopted an alternate model tax convention to the Mexico Draft that promoted greater limitations on the scope of taxation of foreigners earning income within the host country.[118]

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113. The 1920's compromise generally acknowledged the primacy of source taxation with limitations that would allow the taxpayer's country of residence to some foreign source business income and a large portion of passive forms of income, such as dividends, interest and royalties. The current network of international tax treaties has not, in practice, maintained the conceptual framework of the 1920s compromise. *See* Graetz, *supra* note 111, at 261-62.
114. Tax literature generally refers to the country where an investor or business taxpayer has its residence as the "residence country" and the country where the consumer resides or where the income is generated as the "source country."
115. *See* Zapata, *supra* note 80, at 253.
116. *See* Honey L. Goldberg, *Conventions for the Elimination of International Double Taxation: Toward a Developing Country Model*, 15 LAW & POL. INT'L BUS. 833, 852-54 (1983). The 1943 draft treaty entitled "Model Bilateral Convention for the Prevention of Double Taxation of Income" came to be known as the "Mexico Draft." The Mexico Draft included provisions that would permit the source country to tax business profits arising from non-isolated transactions concluded within the borders of the host country; successor treaties restricted source taxation of multinational business profits by focusing on the nature of the enterprise structure (presence of fixed base or permanent establishment) rather than on the nature of the underlying business transaction (isolated sales or regular activities).
117. *Id.*
118. FISCAL COMMITTEE OF LEAGUE OF NATIONS, THE MODEL BILATERAL CONVENTION FOR THE PREVENTION OF THE DOUBLE TAXATION OF INCOME AND PROPERTY (1946). The text and commentary for both the "Mexico Draft" and the "London Model" are *reprinted in* U.N. MODEL, *supra* note 105.

In 1963, the Organization for Economic Cooperation and Development (OECD), which was an association of the world's most industrialized countries at that time, endorsed a bilateral model treaty that replicated the emphasis on residence country taxation promoted by the 1946 London Model.[119] Based on the strong endorsement of developed countries, the OECD Model quickly became the blueprint for numerous bilateral tax treaties between industrialized countries. Virtually all tax treaty negotiations in the world today start with the OECD Model. Under the OECD Model, the source country is expected to drastically curtail the scope of its jurisdiction to tax international income or to lower its rates of taxation where jurisdiction is retained. Because the OECD's purpose is aid its members (developed, industrialized countries) in the negotiation of bilateral tax treaties, the OECD Model favors the administrative convenience of taxation by the income recipient's country of residence.

Most Latin American countries were strongly opposed to the underlying principles of the OECD Model. Some countries proposed a return to the principles outlined in the Mexico Draft, while other Latin American jurisdictions argued for exclusive taxation of income in the country of source. As a way of enhancing the progress and productivity of their economies, several Latin American countries joined forces and formed the Latin American Free Trade Association, also referred to as the Andean Group. In 1971, the Andean Group presented a tax convention that emphasized the principle of exclusive taxation at source.[120] The Andean Group steadfastly supported taxation of multi-jurisdictional income in the source country.[121] Very few capital exporting nations were prepared to accept the territorial principle espoused by the Andean Model and, hence, the Andean Model failed to gain popularity outside of Latin America.[122]

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119. ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, THE MODEL CONVENTION FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXES ON INCOME AND CAPITAL (1963) [hereinafter OECD MODEL]. The OECD Model was revised and republished by the OECD in 1977 and again in 1992. The OECD Model double taxation treaty of 1963 and the revised model tax conventions of 1977 and 1992 form the basis of most modern bilateral taxation treaties.

120. THE MODEL CONVENTION FOR THE AVOIDANCE OF DOUBLE TAXATION BETWEEN MEMBER COUNTRIES AND OTHER COUNTRIES OUTSIDE THE SUBREGION [hereinafter Andean Model] is contained in the COMMISSION OF CARTAGENA AGREEMENT, dated November 16, 1971, and is translated in E. Piedrabuena, *The Model Convention to Avoid Double Income Taxation in the Andean Pact*, *in* FISCAL HARMONIZATION IN THE ANDEAN COUNTRIES 36, Annex N (Atchabahian et al., eds., 1975) [hereinafter FISCAL HARMONIZATION].

121. Regardless of nationality or domicile of the taxpayer, income of any nature obtained shall be taxed only in the Contracting State in which the source of such income production exists, except for those cases mentioned in this Convention. Andean Model, *supra* note 120, art. 4.

122. *See generally* James S. Hausman, *The Andean Pact Model Convention as viewed by the Capital Exporting Nations*, *in* FISCAL HARMONIZATION, *supra* note 120, at 59-64.

Developing countries outside of Latin America asked the United Nations (UN) to develop a model bilateral tax convention that would not be plagued by the various restrictions on source country taxation set out in the OECD Model.[123] The UN model tax convention was introduced in 1980 in order to establish a framework for the negotiation of bilateral tax treaties between developed and developing countries. Due to the imbalance of international trade flows between rich and poor nations, developing countries claimed that the limitations on income taxation in the source country adversely affected capital-importing nations, many of which are developing countries.[124] The UN Model attempts to accommodate the interests of developing countries by expanding the scope of source country taxation relative to the OECD Model and by endorsing, in part, the principle of tax sparing.[125] However, since the UN group of experts used the OECD Model as its primary reference point in drafting the UN Model, many people believe that the final text of the UN Model was overly influenced by the OECD Model.[126] Tax authorities from many developing countries remain opposed to the limitations on source taxation set out in both the OECD Model and the UN Model.[127]

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123. In addition to the inequity of revenue losses, the restrictions on source taxation set out in the OECD Model were perceived by many developing countries as unacceptable limitations on their tax sovereignty. *See* U.N. DEPARTMENT OF ECONOMIC & SOCIAL AFFAIRS, TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES: FIRST REPORT, para. 15 (1969).
124. The residence bias of the OECD Model discriminated against countries that were chronically the country of source in unequal income flow situations. Accordingly, the OECD Model proved unacceptable to developing countries in their negotiations with developed countries. The failure of the OECD Model to accommodate the needs of developing countries was recognized as the most significant factor in the slow progress of treaty negotiations between developed and developing countries. *See* U.N. MODEL, *supra* note 105, Commentary.
125. Tax sparing is the treaty concept designed to protect the fiscal incentives found in the domestic laws of a developing country through an appropriate accommodation by the treaty partner country. Under the tax sparing principle the developed country would agree in the tax treaty to allow a credit to their resident taxpayers on account of a notional amount of taxes that would have been paid to the treaty partner in the absence of the developing country's tax incentive legislation. For discussion of the importance of tax sparing to developing countries, *see* F.N. Dornelles, *The Tax Treaty Needs of Developing Countries with Special Reference to the UN Draft Model*, *in* U.N. MODEL, *supra* note 105.
126. *See* Brian J. Arnold et al., *Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century*, 50 CAN. TAX. J. 65, 78 (2002) (where international tax experts attending a conference in Amsterdam in October, 2001 expressed dissatisfaction with the distinctions, and lack of differences between the OECD and U.N. Models).
127. Many developing nations—especially Latin American countries—shied away from entering into bilateral taxation treaties (until the 1990s) due to the perception that the prevailing rules and norms favored by developed countries represented an unacceptable limitation on the nation's jurisdiction to tax income with a legitimate nexus to the source country. *See* Arnold et al., *supra* note 25, at 1981-84.

### C. Analysis of Tax Conventions of Parties to NAFTA

#### 1. *Cross-Border Business Income*

##### a. Overview

The tax treaty provisions that apply to multi-jurisdictional business income are among the most important clauses in a tax convention, especially from a tax revenue perspective. Because it is quite common for modern business enterprises to carry on commercial activities in two or more states, tax authorities have developed rules that limit the taxation of profits earned by non-residents based on a minimum nexus involving business contact.[128] The treaty article that deals with the taxation of business profits utilizes the concept of "permanent establishment" as the standard for determining the nexus or contact required for source taxation of foreign enterprises. A permanent establishment is defined as "a fixed place of business in which the business of the enterprise is wholly or partly carried on."[129] The bilateral tax convention provision dealing with business profits invariably delineates certain factors or activities that establish the existence of a permanent establishment and expressly excludes other factors or activities from the applicable treaty definition.[130] If a permanent establishment does not exist within the source country, then the business profits will either escape taxation or be taxed only by the residence country.[131] Where a tax treaty seeks to increase those instances when a

128. OECD Model, *supra* note 119, at Commentary (states that it "has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights."

129. OECD Model, *supra* note 119; U.N. Model, *supra* note 105. This wording is found in Article 5, paragraph 1 of both the OECD Model and the UN Model. Most bilateral tax treaties define the term permanent establishment in an article that is separate from the provisions dealing with the taxation of business profits. Certain activities, such as the use of facilities or the maintenance of a stock of goods for the purpose of storage or display, are expressly excluded from the definition of permanent establishment while other activities of the nonresident enterprise, such as the use of certain agents or representatives in the source country, are deemed to constitute a permanent establishment for the purpose of taxation of business income.

130. *See, e.g.*, 1977 U.S. Model, *supra* note 52, art. 5. (defines permanent establishment as "a fixed place of business through which the business of an enterprise is wholly or partly carried on" and proceeds to give examples of a permanent establishment, which would include a place of management, a branch, office, factory, workshop, mine, oil or gas well, quarry, or any other place of extraction of natural resources. The U.S. Model then expressly excludes a number of auxiliary activities, such as "the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise" and "the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise.").

131. It is important to note that if the entity is incorporated in the source country, then it is *prima facie* considered a resident taxpayer of that country. *See*, e.g., Canada's I.T.A. subsection 250(4) (a) (declaring that all companies incorporated in Canada at any time after April 27, 1965 shall be deemed to be residents of Canada for income tax purposes). So the tax treaty provisions establishing the taxation of business profits by a source country are generally only applied to active business

business will be deemed to have a permanent establishment in the foreign country and reduce the number of exclusions, the treaty effectively expands the scope of source country taxation. Conversely, a tax treaty will have a greater residence country bias if it purports to narrow the definition of permanent establishment, thereby further limiting taxation in the country where the income is earned.

Tax treaties typically also establish guidelines for the attribution of business income and expenses to the activities of foreign enterprises. Most model tax conventions provide that business income attributed or connected to a permanent establishment within the source country will be subject to taxation in accordance with the source country's domestic income tax laws.[132] Under U.S. tax law, the profits of a permanent establishment situated in the United States will be determined as though the taxpayer was a distinct and separate enterprise engaged in similar activities under similar conditions and dealing independently of the foreign enterprise that owns the establishment.[133] Varying profit attribution rules could affect the uniformity of tax treatment of transfers between and among taxpayers.

b. Treatment of Business Profits under the Conventions

*(1)Canada-U.S. Convention*

The taxation of business profits under the Canada-U.S. Convention tends to closely follow the text of the OECD Model.[134] Profits of an enterprise of one state will be taxed in the other state only if they can be attributed to a permanent establishment maintained in the other state.[135]

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income when a permanent establishment of an unincorporated company or other foreign entity exists within its borders. It should be noted, though, that multinational enterprises do not necessarily have to carry on most or all of their business in the jurisdiction of incorporation or registration.

132. OECD Model, *supra* note 119, art. 7(2); 1977 U.S. Model, *supra* note 52, art. 7(2).

133. Where a foreign business is resident in a country that has a tax treaty with the United States, U.S. tax authorities will determine all income and expenses effectively connected with the permanent establishment by treating all transfers and remittances from foreign parent to the U.S. branch as though the branch was an arm's length enterprise carrying on the same or similar business as its parent company.

134. The OECD Model, and most existing bilateral tax treaties, relate the jurisdictional nexus for the taxation of international business profits to the concept of "permanent establishment." Article VII(1) of the Canada-U.S. Convention sets out the typical rule for the taxation of multinational business income:

> 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. If the resident carries on, or has carried on, business as aforesaid, the business profits of the resident may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

Convention Between Canada and the United States of America With Respect to Taxes on Income and on Capital, (Sept. 26, 1980), U.S.-Can., art. VII, para. 1.

135. Canada-U.S. Convention, *supra* note 67, art. 5, para. 1. The treaty does not contain language similar to the force-of-attraction principle found in the Canada-Mexico Convention or the U.S.-Mexico Convention.

In determining the profits of a permanent establishment, tax authorities expressly allow the deduction of expenses, including general administrative expenses of the foreign head office, incurred in connection with the permanent establishment. The treaty maintains that the profits of the permanent establishment will be determined as if it were a distinct and separate enterprise engaged in business in the other state. The Canada-U.S. Convention adopts a narrow definition of permanent establishment in comparison to the UN Model. By limiting the scope of taxation of foreign business income by the host country, it could be said that the Canada-U.S. Convention has a relative residence bias.[136]

*(2)Canada-Mexico Convention*

The Canada-Mexico Convention utilizes many of the same provisions found in the Canada-U.S. Convention in respect of the taxation of business profits. However, the Canada-Mexico Convention contains several additional provisions and modifications that effectively grant the source country increased scope to tax the profits of a foreign enterprise.[137] For instance, the Canada-Mexico Convention incorporates a variant of the "force of attraction" principle found in the UN Model by declaring that the source country will be allowed to tax all income derived by the foreign enterprise if the foreigner has a permanent establishment situated in that country, regardless of whether all income is derived from the permanent establishment.[138] The text of the Convention effectively deems sales of similar goods by a related or affiliated company that does not have a permanent establishment in the country to be connected to any permanent establishment of the company in the source country.[139]

The Canada-Mexico Convention accords Canadian and Mexican resident enterprises different treatment than businesses based in the United States. For instance, the Canada-Mexico Convention contains a clause

136. *See id.* art. 7, para. 3.

137. By expanding the definition of permanent establishment in a manner similar to that proposed by the UN Model, the Canada-Mexico Convention broadens the nexus for taxation by the source country. For instance, permanent establishment is deemed to include a building site, a construction, assembly and installation project as well as any supervisory activities in connection therewith, if such activities continue for a period of more than six months. Canada-Mexico Convention, *supra* note 71, art. 5, para. 3. By comparison, the OECD Model and the Canada-U.S. Convention establish a time period of twelve months for such activities.

138. The Canada-Mexico Convention, though, does not go as far as giving the source country jurisdiction over income derived by purchases of imported goods and electronic commerce. "No business profits shall be attributed to a permanent establishment of a person by reason of the mere purchase by the permanent establishment of goods or merchandise for the person." Canada-Mexico Convention, *supra* note 71, art. 7, para. 4.

139. For instance, if a Canadian company with a permanent establishment in Mexico sells goods directly to customers residing in Mexico and the goods are similar to goods sold by a Mexican permanent establishment of the Canadian company, the profits therefrom can be attributed to the permanent establishment and subjected to Mexican tax, unless the Canadian company can establish that the direct sale was carried out for a purpose other than to benefit from the treaty provisions.

not found in the U.S. treaties that expressly prohibits deductions to the permanent establishment for amounts paid to the head office for items such as royalties, commissions, management fees, interest (except for banking enterprises), or similar preferential payments.[140] Furthermore, the Canada-Mexico Convention provides that facilities used solely for delivery of goods or merchandise do not constitute permanent establishments, which provision is apparently aimed at encouraging greater Canadian participation in the Mexican *maquiladora* industry.[141]

*(3) U.S.-Mexico Convention*

Under the U.S.-Mexico Convention, the calculation of business profits subject to taxation in the source country as a result of the existence of a permanent establishment includes income attributable to the permanent establishment as well as the profits generated from sales of goods or merchandise of the same or similar kind as those that are sold through the permanent establishment, but only if the sales were carried out in order to obtain benefits under the treaty.[142] This relatively narrow force-of-attraction principle does not use the same text as the equivalent provision in the Canada-Mexico Convention.[143]

The U.S.-Mexico Convention adopts the arm's length standard of accounting for business profits to be attributed to a permanent establishment. Nonetheless, the Protocol to the U.S.-Mexico Convention permits each country to apply its domestic law relating to the determination of the tax liability of the non-resident taxpayer.[144] This provision is intended to allow Mexico and the United States to determine the profits attributable to a permanent establishment under a unitary, profit-split, ratio-based or other formulary apportionment, if the available information does not allow separate-enterprise accounting and the result is consistent with arm's-length principles.[145] It should be emphasized that the

140. Canada-Mexico Convention, *supra* note 71, art. 7, para. 3. It should be noted that one of the peculiarities of the Mexican tax system is that most purchases can be immediately deducted in calculating profits. Monroy, *supra* note 7, at 742.

141. Canada-Mexico Convention, *supra* note 71, art. 4, para. 4. *Maquiladora* refers to a Mexican entity, usually a wholly-owned subsidiary of a foreign corporation that assembles, manufactures, or otherwise processes inventory or like property for its owner. This provision apparently represented an effort to encourage Canadian businesses to become involved in the maquiladora industry as the overwhelming bulk of maquiladoras are American owned or controlled. BAKER & MCKENZIE, DOING BUSINESS IN MEXICO, 2-3 (1992).

142. U.S.-Mexico Convention, *supra* note 84, art.7, para.1.

143. *See* Greer L. Phillips & John R. Washlick, *The New Income Tax Convention Between the United States of America and the United Mexican States*, TAX NOTES 1447 ( 1992) (where article 7, paragraph 1 of the U.S.-Mexico Convention is described as using the same wording found in the withdrawn 1977 U.S. Model).

144. Reference to domestic tax rules will be permitted in any case where the information available to its competent authority is inadequate to determine the profits to be attributed to the permanent establishment, provided that, on the basis of the available information, the determination of the profits of the permanent establishment must be consistent with the provisions of the treaty. *See* U.S.-Mexico Convention, *supra* note 84, Protocol 1, para. 4.

145. Phillips & Washlick, *supra* note 143, at 10.

U.S.-Mexico Convention differs from most of Mexico's other tax treaties.[146]

### 2. *Dividends and the Repatriation of Profits*

Dividends represent an integral component of foreign direct investment. Chapter 11 of NAFTA applies the principles of National Treatment and Most-Favored Nation Treatment to direct and portfolio investments involving parties from its member countries.[147] One would think that since multinational investors view tax policies setting out the treatment of income and dividends arising out of such investments as important considerations, the Free Trade Agreement would extend its most basic treatment principles to the taxation of investment income. However, income tax measures (including capital gains taxes) are exempted from the application of the relevant provisions of Chapter 11.[148] As a result, it is once again necessary to determine the tax treatment accorded to dividends and branch profits under the pertinent bilateral tax treaties of the parties to NAFTA.

#### a. Overview

Foreign investment is recognized as a crucial element for the economic development of many nations throughout North and South America.[149] The United States has always accounted for a substantial amount of foreign investment in Canada and Mexico as well as in many other countries in the hemisphere; Spain and other European countries made considerable investments in Latin America in the late 1990s.[150] In addition to the

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146. Not only does the U.S.-Mexico Convention differ from most of Mexico's other treaties, but the Convention refers to a situation not contemplated by Mexican tax laws. The Convention definition of permanent establishment states that a U.S. company that merely maintains inventories for processing by a Mexican person with assets provided by the U.S. company (such as the *maquiladora* situation) will not be deemed to be a permanent establishment. In so far as this particular parent-subsidiary relationship has no basis in Mexico's domestic tax laws, "the treaty provision is not legally enforceable." Monroy, *supra* note 7, at 750.

147. NAFTA, *supra* note 1, paragraph 1102(1) (National Treatment) states: "Each Party shall accord to investors of another Party treatment no less favourable than it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation and sale or other disposition of investments." Chapter 11 also extends Most-Favored Nation Treatment provisions to investments involving nationals of a NAFTA member country.

148. "Articles 1102 and 1103 (Investment-National Treatment and Most-Favoured Nation Treatment) . . . shall apply to all taxation measures, other than those on income, capital gains." NAFTA, *supra* note 1, art. 2103, para. 4(b).

149. According to the United Nations Conference on Trade and Development, foreign direct investment in Latin America and the Caribbean rose to $97 billion in 1999 representing a 32% increase over the previous year. *See* Matt Moffett, *Latin America Tops Asia in Luring Foreign Investors*, WALL ST. J., Feb. 22, 2000, at A21 (indicating that 1998 marked the first year where the flow of investment from Europe to Latin America surpassed that from the United States).

150. In 1998, U.S. investments in Latin America totalled roughly $14.3 billion, compared with Spanish investments of $11.3 billion; in 1999, Spanish investments in Latin America rose to almost $20 billion. *See generally* William Glade, *Current Trends and Problems in Foreign Investment in Latin America*, 4 NAFTA: L. &

benefits that a country derives directly from the foreign investment, the country receiving foreign investment may be able to obtain tax revenues from the investment of foreign capital as well as from repatriation of any profits derived from the investment.[151]

Most countries tax the owner or shareholder of an enterprise on dividends and other distributions received from the corporation. Where the dividends are paid to a non-resident, the domestic tax laws of the country that is the recipient of the foreign investment (referred to as the source country in this context) typically imposes a withholding tax obligation on the payor corporation. The payor company is usually required to withhold and remit to the treasury of the source country a certain percentage of the amount of the gross dividend on behalf of the non-resident shareholder. .[152] The shareholder's country of residence may then include the dividend as part of the shareholder's income and impose additional tax. Tax treaties invariably reduce the withholding tax rate imposed by the source country. The combined amount of tax paid by the entity and its owners will be largely influenced by the withholding tax rate set out in the treaty and the domestic tax rates of the respective treaty partners.

The tax treatment of dividend income differs considerably within each of the NAFTA countries. Most notably, Mexico utilizes the exemption model for corporate-shareholder integration and, therefore, does not impose any taxes on dividend income.[153] The revenue implications of domestic tax laws greatly affected the negotiation of the relevant tax treaty provisions dealing with dividends. Under the historical territorial principle, Mexico should have sought to increase source taxation of corporate distributions. However, as a result of not imposing a withholding tax on dividends under its domestic tax laws, Mexico appeared in its treaty nego-

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Bus. Rev. Am. 57, 60 (Spring 1998) (finding that Spanish investment was concentrated in the resources, manufacturing and utilities sectors of several Latin American countries). Most notably, the United States continues to be the greatest investor in telecommunications and e-commerce technologies throughout the Americas as demonstrated by several high-profile examples of U.S. direct investment in Latin America. *Id.*

151. Investments by multinational enterprises can deliver a number of the following benefits to the host country: injection of needed capital; increased employment; introduction, transfer or spill over of technology; introduction of sophisticated management skills; increased competition in the host country market; and increased foreign exchange earnings. Eric M. Burt, *Developing Countries and the Framework for Negotiations on Foreign Direct Investment in the World Trade Organization*, 12 Am. U.J. Int'l L. & Pol'y 1015, 1021 (1997).

152. Under domestic United States tax law, the withholding tax rate for dividends paid to a non-resident of a non-treaty country is 30% of the gross dividend, whereas in Canada the statutory rate is 25% of the gross dividend.

153. In general, profits previously taxed by the Mexico government at the corporate level are not subject to further taxation and all corporate entities are treated the same regardless of their organizational structure. Monroy, *supra* note 7, at 744. More technically, dividends paid by Mexican corporations out of earnings that have been subject to corporate income tax are exempt from further taxation when received by the shareholder, while any dividend in excess of net after-tax profits will still be exempt from tax in the hands of the shareholder, but will trigger a compensatory tax on the payor corporation. *See* Phillips & Washlick, *supra* note 143, at 1451.

tiations with Canada and the United States to be most interested in reducing or eliminating the taxation of dividends at source.[154] All three of the NAFTA treaties stipulate a low rate of withholding tax on the gross amount of dividends where the shareholder owns a significant percentage of the payor corporation and a higher level of withholding tax on dividends arising from more passive investments, commonly referred to as "portfolio dividends."[155]

Foreign investment does not necessarily involve the use of a corporate entity. Where a foreign enterprise chooses to carry on its local business activities in a branch form, there exists the possibility that the enterprise could avoid the host country's withholding tax that applies to dividends. In order to minimize this significant tax difference between foreign branches and incorporated subsidiaries, the host country will strive to tax any distribution of corporate profits from the branch operation to the head office. In instances where a foreign branch constitutes a permanent establishment in the source country, the source country may levy an additional tax on the profits of the branch that are repatriated to head office.[156] Most of the tax treaties concluded by Canada and the United States impose a withholding tax on distributions from a branch office that is separate from the rate of withholding tax imposed on dividends.

b. Treatment of Dividends and Branch Remittances under the Conventions

*(1)Canada-U.S. Convention*

The Canada-U.S. tax treaty provides that the source country shall not impose a withholding tax on dividends greater than 10 percent if the recipient's share of equity or control in the payor corporation is in excess of 10 percent. In all other cases the source country may impose a withholding tax of up to 15 percent of the gross dividend payment.[157] The Canada-U.S. Convention also makes provision for the imposition of a branch tax of 10 percent of the amount of earnings repatriated by the branch; however, the effect of the complicated branch tax provision in the treaty is to reduce the real rate of taxation of branch profits at source to well below 10 percent.[158]

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154. *See* Phillips & Washlick, *supra* note 143, at 1451.
155. Integration of taxation is one of the most important considerations for wholly-owned subsidiaries of multinational enterprises whereas there are a variety of factors that influence the international taxation of portfolio dividends. *See* DONALD J. BREAN ET AL, TAXATION OF INTERNATIONAL PORTFOLIO INVESTMENT, 57-71 (1991).
156. Canada and the United States both impose an additional tax on distributions of branch profits, which is referred to as a "branch tax." Consistent with its use of the exemption model of integration Mexico generally does not tax distributions of branch profits. The imposition of a branch tax has the effect of minimizing the disincentive to carry on business operations in the parent-subsidiary form.
157. Canada-U.S. Convention, *supra* note 67, art. 10, para. 2.
158. *See* Canada-U.S. Convention, *supra* note 67, art. 10, para. 6 (which defines the term "earnings" as the excess of business profits attributable to all permanent establishments for the year and previous years over the sum of: (a) business losses

*(2) Canada-Mexico Convention*

The Canada-Mexico Convention restricts the withholding tax rate imposed by the source country on dividends paid to non-residents to no more than 10 percent of the gross amount of the dividends where the beneficial owner is a company that controls 25 percent or more of the voting power of the company paying the dividends and to no more than 15 percent of the gross amount of the dividend in all other instances.[159] The Convention also contains a provision that permits each country to impose a branch tax of up to 10 percent of the earnings of the branch office situated in the country.[160] The Canada-Mexico Convention further provides that when determining taxation of dividends in Canada, a tax of 15 percent shall be deemed to have been paid on a dividend paid by a company that is a resident of Mexico, provided the earnings of the said company are primarily from business carried on in Mexico.[161] This provision is designed to benefit Canadian investors interested in acquiring an equity position of a Mexican-based company.

*(3) U.S.-Mexico Convention*

Under the U.S.-Mexico Convention, the rate of source country taxation of dividends paid to a corporate shareholder that owns at least ten percent of the voting stock of the payor cannot exceed 5 percent.[162] The rate of withholding tax for all other dividends will be 15 percent for the first five years that the Convention is in force and 10 percent thereafter. The Protocol to the Convention provides Most-Favored Nation Treatment to Mexico. In the event the United States agrees in a treaty with another country to a withholding tax rate that is lower than 5 percent, then the lower rate would also apply under the Convention.[163] Mexico appears to foregoing a considerable amount of revenue due to its failure to collect withholding tax on international dividend and branch distributions, particularly when one considers the huge amount of American foreign investment in Mexico.[164]

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attributable to the permanent establishments for such years; (b) all taxes on profits whether or not covered by the Convention; (c) profits reinvested in the host state; and (d) $500,000 CDN$ or its equivalent in US$).

159. *See* Canada-Mexico Convention, *supra* note 71, art. 10, para.2. The provisions appear to benefit Canada as Mexico does not impose a withholding tax on distributions of dividends.
160. Canada-Mexico Convention, *supra* note 71, art. 10, para. 6.
161. *See* Canada-Mexico Convention, *supra* note 71, art. 22, para. 3.
162. U.S.-Mexico Convention, *supra* note 84, art.10, para.2.
163. U.S.-Mexico Convention, *supra* note 84, protocol 1, para. 8(b).
164. When NAFTA was signed in 1992 the United States accounted for approximately 61% of Mexico's cumulative foreign direct investment by value; in 1991 alone, the amount of U.S. direct investment in Mexico was $11.6 billion compared to Mexican direct investment of only $0.6 billion in the United States. Jay Camillo, *Growth Through North American Trade: The Economic Facts*, Bus. Am. 12, 13 (Oct. 1992).

### 3. *Royalties and Payments in Respect of Intellectual Property*

#### a. Overview

NAFTA emphasizes the need for clearly defined intellectual property rights. Chapter 17 of NAFTA contains various rules that impact on royalty payments, such as literary, dramatic and musical copyrights, and the protection of intellectual property, such as patents and trademarks.[165] Bilateral income tax treaties rely upon the proper characterization of an item of income in order to determine the appropriate treatment of the taxpayers and transactions. Software and e-commerce transactions often represent a sale or license of a bundle of rights and benefits, so it is not always clear how the supply and the income derived from the transaction should be taxed. The characterization of income derived from the licensing or transfer of an intangible good or service represents one of the most challenging aspects of developing tax rules for the digital environment. For instance, license fees in connection with the sale of software can be treated as royalty payments because such payments are essentially remuneration for the right to use copyrighted material or they may be treated as business income in so far as such fees constitute remuneration for sales of inventory in the ordinary course of business.

If a payment is categorized as a royalty, then the country of source typically levies a withholding tax on the gross amount of the royalty payable to the non-resident. The recipient's country of residence (referred to as the residence country) would generally impose further tax on the royalty payment in accordance with its domestic tax rules for residents and subject to credit for foreign taxes paid. However, if the payment is treated as income earned in the course of business, then the tax treatment of such income would change completely.[166]

When used in the context of bilateral tax treaties, the term "royalties" commonly refers to payments for the use of, or the right to use (a) any copyright of literary, artistic or scientific work and including production of motion picture and television films; (b) any patents, trademarks and other rights of a similar nature; and (c) industrial, commercial or scientific

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165. The drafters of NAFTA recognized the trade-off between encouraging research and development through protection of proprietary rights on one hand and the promotion of free and unfettered trade on the other hand. Chapter 17 (Intellectual Property), para. 1, declares that: "Each Party shall provide in its territory to the nationals of another Party adequate and effective protection and enforcement of intellectual property rights, while ensuring that measures to enforce intellectual property rights do not themselves become barriers to legitimate trade."

166. *See generally* ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, TAX TREATY CHARACTERIZATION ISSUES ARISING FROM ELECTRONIC COMMERCE (Feb. 1, 2001) (reviewing a number of fact scenarios and advising tax authorities of OECD member states to treat most electronic commerce transactions as generating active business income). The Technical Advisory Group responsible for the discussion proposals on characterization issues explained that even though license fees represented the capture and use of digital copyrighted information, such information was usually just the by-product of the e-commerce transaction and that the real purpose of most commercial transactions is to earn income for the business.

equipment and information in respect thereof. Royalties are generally sourced with reference to the residence of the payor. If the payor has a permanent establishment or fixed base in a treaty country that incurs the liability for the royalty, then the treaty will treat the royalty payment as having its *situs* in the country where the permanent establishment or fixed base is situated. Under both the OECD Model and the U.S. Model, the residence country has exclusive jurisdiction to tax all royalty payments.[167] Since royalty payments usually flow from developing countries to industrialized developed nations, the approach adopted by the OECD Model and the U.S. Model would lead to significant losses of tax revenue for developing countries. By considering the tax treatment accorded royalties under the applicable tax conventions of the parties to NAFTA, it brings into the focus the tension between pursuit of the fiscal demands of treaty partners and the objectives of mutual advantage and harmonization promoted throughout the Free Trade Agreement.

b. Tax Treatment of Royalties under the Conventions

*(1)Canada-U.S. Convention*

The Canada-U.S. Convention limits the rate of withholding tax on foreign royalties to 10 percent of the gross royalty payment. While this treaty deviates materially from the treatment accorded royalty income under both the OECD Model and the U.S. Model, there is a provision in the Convention exempting royalties arising from the production or reproduction of any literary, dramatic, musical or artistic work from withholding tax. Most notably, though, the Canada-U.S. Convention does not extend the cultural royalty exemption toroyalties relating to motion pictures, television films, and other means of reproduction of television signals, which continue to be subject to the treaty's withholding tax rate of 10%.[168]

*(2)Canada-Mexico Convention*

The Canada-Mexico Convention provides for the country of source to impose a withholding tax of no more than 15 percent on royalties paid to foreign residents. The Protocol to the Convention states that if pursuant to a treaty concluded with a member of the OECD, Mexico agrees to a rate of withholding tax on royalties that is lower than 15 percent, such lower rate (but not below 10 percent) shall apply with respect to taxation

167. *See, e.g.*, OECD Model, *supra* note 119, art. 12 (supporting exclusive residence country taxation of royalty payments on the grounds that the recipient of the royalty should be allowed over the long term to match its research and development costs against its royalty income regardless of where such expenses and revenues were incurred).

168. Canada claims that the balance of royalty payments, especially in respect of motion pictures, television films and video reproduction, is weighted too heavily in favour of the United States to permit exclusive residence country taxation. *See* CANADA'S TAX TREATIES, *supra* note 69.

of royalties.[169] The Canada-Mexico Convention exempts from taxation in the source country all copyright royalties and other like payments in respect of the production or reproduction of any cultural, dramatic, musical or other artistic work. The exemption for cultural royalties does not extend to royalties in respect of motion picture films or reproductions for use in videos or television.[170]

*(3) U.S.-Mexico Convention*

The U.S.-Mexico Convention permits the source country to tax royalty payments at a rate of 10 percent of the gross amount of the royalty.[171] Most importantly, the U.S.-Mexico Convention differs from the other two bilateral tax treaties between NAFTA signatories by failing to exempt any form of royalty payment from taxation in the source country. In order to conclude this treaty with Mexico, it was clear that the United States had to move away from its objective of zero withholding at source as established by the U.S. Model. Nonetheless, the United States did succeed in limiting taxation of royalties at source to 10 percent, which represented a significant reduction from the withholding tax rates that would have been imposed under Mexican tax law in the absence of a tax treaty.

### 4. *Income from Independent Personal Services*

a. Overview

NAFTA applies the basic trade principles of National Treatment and Most-Favored Nation Treatment to the performance of services across borders.[172] The taxation of income derived from cross-border trade in services is, to a certain extent, integrated within the Free Trade Agreement.[173] In this respect, the harmonization and integration of rules for the service sector has been cited as one of the most notable benefits of NAFTA.[174] The taxation of personal services represents an area where North American tax authorities have interacted with NAFTA trade rep-

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169. As the Protocol to the Canada-Mexico Convention contains a Most-Favored Nation provision that applies to royalties, the subsequent ratification of the U.S.-Mexico Convention effectively reduced the rate of withholding tax in the Canada-Mexico Convention to 10%. Although the objective of harmonization appears to have been promoted in respect of the withholding tax rate, the exemption and inclusion provisions in respect of the taxation of royalties differ from treaty to treaty.

170. Canada-Mexico Convention, *supra* note 71, art. 12, para. 3.

171. U.S.-Mexico Convention, *supra* note 84, art. 12, para.2.

172. Article 1202 of NAFTA states: "Each Party shall accord to service providers of another party treatment no less favourable than that it accords, in like circumstances, to its own service providers."

173. Article 2103(4)(a) of NAFTA extends the application of the National Treatment provisions of NAFTA Article 1202 (Cross-Border Trade in Services—National Treatment) to taxation measures on income.

174. In requiring its Member States to commit to exchanges in services in the roughly the same manner as trading of goods, NAFTA goes beyond the World Trade Organization's General Agreement on Trade in Services (GATS), which does not require countries to make any basic commitment to free trade in services. *See* Mann, *supra* note 6, at 226-28.

resentatives in an effort to harmonize the treatment of cross-border exchanges of services.

Remuneration derived by individuals from the performance of services must be classified under most bilateral tax treaties as either (a) income from dependent personal services, or (b) income from the performance of independent personal services. Most countries accept the principle that a nation has a legitimate claim to impose tax on income derived from the exercise of dependent personal services, such as office and employment income within its boundaries.[175] However, where personal services are independent in nature, the income derived by such services are treated akin to business profits. All of the NAFTA tax conventions treat independent personal service income derived by non-residents in a manner similar to the taxation of business profits. Income derived from the exercise of professional services and other services of an independent nature will be taxed in the source country only if the foreigner maintains a physical presence in the host country. Whereas the concept of permanent establishment is usually reserved for commercial activities of a corporate nature, the equivalent concept of "fixed base" applies to the taxation of income from independent personal services.[176]

The fixed base requirement generally provides that a host country will only tax income from independent personal services performed by a non-resident if the non-resident uses a fixed base in the host country to perform the services. Many countries, particularly developing countries, have expressed the view that the existence of a fixed base requirement for taxation by the host country is not justifiable in principle.[177] Their arguments eventually resulted in modifications to the standard fixed base test becoming more commonplace. Therefore, treaties impose additional requirements that must be satisfied prior to the country asserting the right to tax income from personal services of an independent nature. For instance, some bilateral tax treaties assign exclusive jurisdiction to tax personal service income to the service provider's country of residence only if the service provider is not present in the host country for a specified time period, usually 183 days.

b. Tax Treatment under NAFTA Conventions

*(1)Canada-U.S. Convention*

The Canada-U.S. Convention sets out the basic rule that income from independent personal services may only be taxed in the source country if the individual has or had a fixed base regularly available to him or her in

175. *See* Robert J. Patrick Jr., *A Comparison of the United States and OECD Model Income Tax Conventions*, 10 LAW & POL'Y INT'L BUS. 650, 673 (1980).

176. Although many treaties do not define the term "fixed base," the international consensus is that it is similar to permanent establishment and would include facilities such as a physician's consulting room and the offices of a lawyer or an accountant. *See* U.N. MODEL, *supra* note 105, Commentary to art. 14.

177. *See* U.N. Model, *supra* note 105, Commentary to art. 14.

the source country.[178] If it is determined that the taxpayer has a fixed base in the country where the income is earned, the source country may tax only the income that is attributable to the fixed base of the taxpayer in the country.

*(2)Canada-Mexico Convention*

The Canada-Mexico Convention provides that if a resident of Canada or Mexico has a fixed base regularly available in the other country for the purpose of performing professional services or other activities of an independent nature, then the other country may tax the income that is attributable to the fixed base. In addition to establishing the general rule found in the equivalent section of the Canada-U.S. Convention, the Canada-Mexico Convention applies a presence test for the taxation of independent service income. The taxpayer will be considered to have a fixed base in the source country if throughout any twelve-month period the resident is present in that country for more than 183 days in aggregate.[179] Thereby the Canada-Mexico Convention provision for taxation of independent personal services provides a moderately broader scope for source country taxation than the other two bilateral treaties governed by NAFTA.

*(3)U.S.-Mexico Convention*

The U.S.-Mexico Convention treats income from the performance of independent personal services in a similar manner to the treatment accorded such income under Mexico's treaty with Canada. However, the U.S.-Mexico Convention (unlike the Canada-Mexico Convention) does not make any reference to length of stay as a condition for taxation of the foreigner by the host country.

The Conventions between NAFTA member countries are relatively consistent in their tax treatment of income from independent personal services. By treating income from the performance of independent services in the same manner as business profits, each of the NAFTA Conventions restricts the right of the source country to levy tax on the income, unless the taxpayer has a fixed base in the source jurisdiction. The simple extension of the Free Trade Agreement's National Treatment principle to the taxation of service income effectively contributed to the promotion of uniform treatment in the supporting bilateral tax treaties.

## IV. THE EMERGENCE OF ELECTRONIC COMMERCE

*"New conditions require new rules of fair trading, and since conditions always change and evolve, the Heaven of totally free trade is – as*

178. Canada-U.S. Convention, *supra* note 67, art. 14.

179. Canada-Mexico Convention, *supra* note 71, art. 14, para.1.

*Pope said- always just beyond our grasp."*[180]

### A. E-Commerce and International Trade Negotiations

Only a few years after NAFTA was concluded, the Internet revolution led to the computer being a mainstay in many North American homes and offices. Fully anticipating the revolutionary and rapid impact of information technologies would have been difficult when the text of the Free Trade Agreement was completed in 1992. NAFTA negotiations focused on the trade of physical goods and services across clearly drawn borders. The surging popularity of the Internet and the recent growth of e-commerce dramatically changed the nature and economics of global business.[181] Digital transactions blur the application of international trade and tax rules in so far as electronic commerce does not adapt nicely to conventional trade agreement definitions and concepts. The unprecedented technological developments of the past few years have had a greater impact on the globalisation of economic trade than the drafters of NAFTA could have envisaged.[182] NAFTA, like many other agreements of its era, fails to adequately address a variety of complex issues that have arisen as a result of the growth of electronic commerce.[183] This section will briefly discuss the various tensions that co-exist in the effort to bring electronic commerce within the scope of international trade negotiations.

#### 1. *International Efforts to Respond to E-Commerce*

Several multilateral organizations have addressed the challenges and issues for the taxation of electronic commerce. The Organization for Economic Cooperation and Development (OECD) is the primary multilateral organization developing rules and policies to adapt tax measures to electronic commerce.[184] Canada, Mexico, and the United States all belong to the OECD, which is also at the forefront of discussions relating to the economic and social impact of e-commerce.[185] The United Nations

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180. Richard O. Cunningham, *NAFTA in the Global Context*, 23 CAN.-U.S. L.J. 379, 382 (1997) (where the author indicates that electronic commerce will probably exaggerate the conflict or tension between those that favor unimpeded trade and those that perceive the need to use trade restrictions as a lever for social or political objectives).
181. For a discussion on the economics of e-commerce, *see* ELECTRONIC COMMERCE AND DEVELOPMENT, U.N. COMMISSION ON TRADE AND DEVELOPMENT 14-16, *available at* http://www.unctad.org.
182. *See generally* DOUGLAS A. IRWIN, AGAINST THE TIDE: AN INTELLECTUAL HISTORY OF FREE TRADE (1995).
183. *See* THOMAS ANDREW O'KEEFE, LATIN AMERICAN TRADE AGREEMENTS (1997); and Claudio Grossman, *The Evolution of Free Trade in the Americas: NAFTA Case Studies*, 11 AM. U. J. INT'L L. & POL'Y 687 (1996).
184. Committee on Fiscal Affairs, OECD, ELECTRONIC COMMERCE: A DISCUSSION PAPER ON TAXATION ISSUES (Paris: OECD, Sept., 1998), 18, para. 38 (the OECD claims that "problems concerning the application of consumption taxes are generally recognised as having more immediacy than the issues concerning direct taxation.").
185. *See* OECD, The Economic and Social Impact of Electronic Commerce: Preliminary Findings and Research Agenda 12 (1999). The OECD is a multilateral organ-

Commission on International Trade Law offers a model law on electronic commerce with particular focus on the legality of the electronic contract.[186] The Organization of American States, together with free trade and business alliances, has organized a group to respond to the legal obstacles to electronic commerce in Latin America.[187] Already, different determinations and classifications in respect of e-commerce have emerged as a point of conflict in trade negotiations involving the United States and other countries.[188] NAFTA avoids some, but not all, of the trade nuances relating to the classification of e-commerce goods because it purports to treat trade in services in a manner relatively similar to trade in goods. Early indications are that the classification conflicts taking place in other international trade forums may find a new battlefield in the FTAA.[189]

### 2. *Online Transactions Involving Physical Goods*

E-commerce can be readily distinguished into an exchange of either a tangible product or an intangible product.[190] It should be noted that in so far as e-commerce involves the sale or purchase of physical goods and services, the usual provisions of the Free Trade Agreement would apply. So, where the computer is used to promote the sale of tangible goods and services in the marketplace, it is comparable to other modern telecommunication devices, such as telephone and facsimile machines. E-commerce transactions involving the sale and delivery of physical goods and services should be treated, for trade purposes, in the same manner as traditional goods and services.[191] From a tax perspective, e-commerce involving tan-

ization comprised of thirty member countries that share "a commitment to democratic government and the market economy." Documents and objectives available at http://www.oecd.org.

186. Mann, *supra* note 6, at 221-22.

187. The Organization of American States, the National Law Center for Inter-American Free Trade and the Business Software Alliance jointly organized a conference in 1999 entitled RESPONDING TO THE LEGAL OBSTACLES TO ELECTRONIC COMMERCE IN LATIN AMERICA, *available at* http://www.natlaw.com/ecommerce/index.htm.

188. Generally, the United States has pursued a broader definition of goods in trade discussions in order to include Internet products under the stringent requirements of GATT whereas other countries argue that electronic deliveries constitute trade in services and should be governed by GATS. Mann, *supra* note 6, at 222.

189. The European Union and the World Trade Organization apply different standards to "goods" and to "services." *See* Catherine L. Mann & Sarah Cleeland Knight, *Electronic Commerce in the World Trade Organization*, *in* THE WTO AFTER SEATTLE 19 (Jeffrey J. Schott ed., 2000); William Drake & Kalypson Nicoliades, *The Information Revolution and Services Trade Liberalization After 2000*, *in* GATS 2000: NEW DIRECTIONS IN SERVICES TRADE LIBERALIZATION 241 (Pierre Sauve & Robert Stern eds., 2000).

190. This section will focus exclusively on the use of the Internet and other modern technologies for the transfer or purchase of tangible products.

191. Tangible or physical goods ordered over the Internet are usually subject to the same system of taxes and tariffs that apply to goods ordered over the telephone or through a mail order catalogue. For the most part, the collection of sales taxes and import duties on physical goods usually occurs at the border between countries. The e-commerce purchaser of a physical product will typically have to pay any

gible products still presents a series of challenges for tax authorities because the prevailing system of international income taxation is predicated on the correlation between sales activity and a physical presence in the market jurisdiction. While the application of National Treatment and other basic trade principles to increasingly global businesses has been recognized as an important element of future international trade negotiations, the necessity of according uniform tax treatment to e-commerce as a mechanism to remove trade impediments has received scant attention.[192]

### 3. *The Impact of the Global Digital Divide on Trade Issues*

The United States is recognized as the world leader in electronic commerce, telecommunications, and information technologies. Nonetheless, the U.S. is plagued by considerable digital disparity among its own citizenry.[193] On an international level, the differences between the technological "haves" and "have-nots" give rise to a "global digital divide" characterized by huge worldwide discrepancies in information technologies, electronic commerce, and Internet use.[194] The substantial disparity in Internet use and electronic commerce between the United States, on one hand, and Mexico and other Latin American countries, on the other hand, raises concern about the future of international trade negotiations within a digital environment.[195]

While the United States has been proactive in introducing electronic commerce into regional trade negotiations, the growing digital divide within the hemisphere has contributed to disapproval or outright rejection of most U.S. proposals.[196] The perception in many developing coun-

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applicable sales or transaction taxes upon the entry of the good into the buyer's country. For instance, since all taxable supplies into Canada are subject to a federal goods and services tax of 7%, the Canada Customs and Revenue Agency collects the GST together with any applicable provincial retail sales or harmonized sales tax upon the product entering into Canada. Mexico similarly imposes a value-added tax on goods, services and other imports of tangible and intangible products into Mexico. The general rate of Mexico's VAT is 15%, but the rate is reduced to 10% along the border area with exemptions provided for exported products. Monroy, *supra* note 7, at 743.

192. *See* Amelia H. Boss, *Electronic Commerce and the Symbiotic Relationship Between International and Domestic Law Reform*, 72 TUL. L. REV. 1931 (1998) (where it is claimed that the advent of electronic commerce requires a symbiotic relationship between domestic and international legal reforms, trade policies and disparate legal systems).
193. *See* CLINTON-GORE, *supra* note 9.
194. *See* Spectar, *supra* note 9.
195. For a detailed study of electronic commerce issues in Latin America, *see Electronic Commerce in the Western Hemisphere: An Ongoing Series*, Inter-American Trade Report, *available* at http://www.natlaw.com/bulletin/1999.
196. For evidence of how the U.S. and EU have alienated developing countries by demanding international consensus on Internet regulation, *see* Steven M. Hanley, *International Internet Regulation: A Multinational Approach*, 16 J. MARSHALL J. COMPUTER & INFO. L. 997 (1998). For a discussion of the conflicting positions adopted by the United States and less developed countries in respect of the normative framework established by the "New World Information and Communications Order," *see* Spectar, *supra* note 9.

tries appears to be that U.S. efforts at bringing e-commerce into an international trade regime have been motivated by self-interest.[197] Mexico, though, has adopted a different stance on technology issues than some of its Latin American counterparts by embracing the need to bring e-commerce within the framework of international free trade.[198] Some have argued that Mexico's nascent but growing e-commerce sector may finally be prepared to take genuine advantage of the global trade possibilities provided by NAFTA.[199]

Whether electronic commerce will be a boon for the emerging economies of Latin America remains to be seen. The revolution of the Internet provides global accessibility to information technologies, the underlying products, and a whole series of new markets.[200] The global digital divide prevents less developed countries from taking advantages of the economic efficiencies associated with new technologies. Nations appear united in their intention to narrow the information and communications gap between developed and developing countries, but have varying opinions as to how to attain this goal.[201] At the very least, the existence of the global digital divide highlights the importance of tax and trade rules based on the concept of mutual advantage. International trade agreements that address electronic commerce concerns in an equitable manner would go a long way towards assuaging the fears of developing countries.[202] U.S. dominance of electronic commerce will, at least in the short run, necessitate the implementation of proactive international trade rules that apply to e-commerce while recognizing the need to preserve the eco-

197. "Major trading nations, led by the United States, have systematically exercised a sort of neomercantilist strategy by introducing electronic commerce into global trading arrangements to enhance their own wealth, power and market access at the expense of others." Wiwit Wirsatyo, *E-Commerce at Global Negotiation*, JAKARTA POST (Mar. 31, 1999) (where it is claimed that developing countries are worried because as a result of their relative lack of technological capacity, they will become e-commerce consumers rather than producers, which will lead to the erosion of local and national languages and cultures).

198. For instance, former Mexican President Ernesto Zedillo claimed that e-commerce had the potential to spur crucial economic growth for developing countries, and that "the biggest betrayal of those poorest people would be to try to tell them that you don't need electronic commerce, or suggest to them one way of getting something out of the WTO is to block electronic commerce." *WTO Chief, Mexico President: Free Trade Failure Only Hurts Poor*, DOW JONES INT'L NEWS SERV. (Jan. 28, 2000).

199. *See* Brendan M. Case, *Mexican E-Ventures: Businesses South of Border Discovering Potential Online*, DALLAS MORNING NEWS, Jan. 12, 2000, at D1; *see also* REPORT WITH RECOMMENDATIONS TO MINISTERS, FTAA JOINT GOVERNMENT-PRIVATE SECTOR COMMITTEE OF EXPERTS ON ELECTRONIC COMMERCE, *available at* http://www.ftaa-alca.org.

200. Mann, *supra* note 6, at 222 (indicating that the Internet has created unique, new and substantial markets in time, geography and information).

201. *See* Spectar, *supra* note 9.

202. *See* Willingham, *supra* note 5, at 492, 493 & 506 (where it is argued that the FTAA should be doing more to promote e-commerce infrastructure development within its member countries because only two—Canada and the United States—of the thirty-four FTAA countries are currently in any position to take advantage of the electronic commerce revolution).

nomic interests of the less technologically sophisticated.[203] With respect to the argument in this article for greater tax integration within NAFTA, the guiding principle in developing such tax rules must be the distribution of revenues from global commerce in a manner that is fair and advantageous to the fiscal interests of the source or market country.

### B. Electronic Commerce and the Challenge to Tax Authorities

This section briefly explains why tax authorities are reporting serious difficulties in administering and collecting taxes in a digital environment.[204] E-commerce transactions involving intangible goods and services present a series of challenges for most tax administrations. The anonymous nature of the Internet plagues tax authorities that need to identify taxpayers and taxable transactions in order to collect an income tax. The greatest difficulties faced by some governments, particularly in the United States, pertain to the collection of sales, use, and other transaction taxes.[205] This section concludes by highlighting the awkward responses of international tax authorities that attempt to bring e-commerce

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203. *See* Willingham, *supra* note 5, at 500.

204. While it is admittedly difficult to estimate tax losses connected to e-commerce, the United States General Accounting Office projected revenue losses at between $1 billion and $12.4 billion for the year 2003 due to states and localities being unable to tax e-commerce sales. *See* General Accounting Office, Sales Taxes: Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain (June 2000), at 20-21. *See also* Austan Goolsbee & Jonathan Zittrain, *Evaluating the Costs and Benefits of Taxing Internet Commerce*, Nat'l Tax J. 413, 413-28 (1999) (estimating a loss to U.S. state treasuries of less than 2% of current state revenues). For a more international perspective, *see* Susan Teltscher, Revenue Implications of Electronic Commerce: Issues of Interest to Developing Countries, UNCTAD (Apr. 2000) (calculating a loss of tax revenues of approximately one per cent overall with significant variance among countries).

205. The United States is probably the best example of how Internet taxation—or more appropriately the lack of coherent tax rules—has created problems for tax authorities and increased compliance costs for multi-jurisdictional enterprises. The replacement of traditional retailers with "e-tailers" has contributed to huge revenue losses throughout various levels of government. The U.S. Treasury acknowledged that e-commerce would adversely impact the collection of state and local tax revenues. *See* U.S. Department of the Treasury, Selected Tax Policy Implications of Global Electronic Commerce (1996). The multiplicity of states, counties, cities, towns and special districts that impose sales, use and other transaction taxes without a uniform base tremendously increases the complexity of complying with tax laws in the United States. Out of concern that conflicting and overlapping sales and use taxes would hinder the growth of electronic commerce, then President Clinton's declared that: "We cannot allow 30,000 state and local tax jurisdictions to stifle the Internet." U.S. Government Working Group on Electronic Commerce, First Annual Report (1998). Under the auspices of allowing e-commerce to grow without being stifled by new or additional state taxes, in 1998 the U.S. Congress passed the Internet Tax Freedom Act, Public Law No. 105-277, 112 Stat. 2681 (1998). The federal legislation, which restricts state and local tax authorities from imposing any new or discriminatory taxes involving Internet access, electronic commerce or related digital technologies, was renewed for a further two year term in November 2001 and is now due to expire in November 2003.

profits into the tax fold by focusing on the fiscal attributes of the technology.

### *1. The Difficulties of Taxing Intangible Goods and Services*

The quintessential electronic commerce transaction involves the sale and delivery of intangible products and services through the use of computer networks. Music, video games, software, pornography, gambling, banking, and travel services are some of the most popular items procured over the Internet. Electronic commerce represents a challenge to tax authorities because the whole process of marketing, distribution, payment, and delivery of an intangible good or service can be completed electronically without the need for physical delivery of the product or human contact between the consumer and the e-commerce vendor. The intangible nature of electronic commerce eliminates the paper trail that is a fundamental component of international tax audit and verification practices of most modern self-reporting systems.

E-commerce transactions involving intangible goods and services have had a significant effect on the consumption tax base of each of the NAFTA countries. It is far more difficult to collect sales and other transaction taxes on digital products or services using traditional sourcing rules.[206] The determination of the appropriate taxing jurisdiction is particularly problematic for intangible e-commerce transactions. Business conducted over the Internet blurs the importance of national borders. The relatively anonymous nature of the Internet befuddles tax authorities by obscuring the existence of cross-border transactions.[207] Theoretically, little justification can be proffered to support the claim of the jurisdiction that hosts the e-commerce business to apply its taxes on the remote sales of the e-commerce business. From a practical perspective, it is extremely difficult for the jurisdiction where the consumer resides to impose its sales and use taxes on digital products and services downloaded or consumed by its residents in the same manner as the taxation of tangible equivalents.

Business-to-business trade generally accounts for about 80 percent of all e-commerce.[208] Businesses increasingly order and deliver products and services by electronic means. In many cases, related companies

206. *See* Schadewald & Kaye, *supra* note 36, at 355.

207. In so far as it is difficult to tax something that does not exist, it is comparably challenging to request information that may not be available. So, although North American nations have executed bilateral exchange of information agreements with most of their major trading partners, it is unclear whether any of these agreements could be effectively applied to obtain verifiable digital information.

208. *See* ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, THE ECONOMIC AND SOCIAL IMPACTS OF ELECTRONIC COMMERCE: PRELIMINARY FINDINGS AND RESEARCH AGENDA, 50-51 (1999) (even though the e-commerce business-to-consumer sector is growing exponentially in North America, the sector is still only one-quarter of the business-to-business sector in North America and has not reached the retail e-commerce penetration levels of Sweden and a few other European countries).

share, lend, or give each other the right to use or mutually benefit from intellectual property rights, information technologies, and other intangibles owned by the group. The exponential growth in the amount of trade and transfer of goods and services in the business-to-business sector has led to serious concerns regarding the manipulation of transfer prices by related companies, particularly in respect of intangible goods and services.[209] The adoption of similar transfer pricing rules among the Member States of NAFTA would go a long way towards relieving ambiguities and disparities in the treatment of tangible and intangible cross-border business transactions.[210]

International trade negotiations under the World Trade Organization have been deeply affected by decisions to classify intangible e-commerce products as goods or services.[211] While NAFTA does distinguish between the cross-border trading of goods and the international delivery of services, the Free Trade Agreement generally applies both the National Treatment principle and Most-Favored Nation Treatment to the trade of goods and to services in a manner not found in other international trade agreements.[212] The United States appears to be particularly interested in ensuring that the classification of an electronic transaction as involving the sale of either an intangible good or service is included in its international trade agreements.[213]

### 2. *Identification Problems on the Internet*

Taxpayer identification is considered a fundamental prerequisite for the imposition of income taxation in most countries.[214] However, tax au-

209. *See* David L. Forst, *Old and New Issues in the Taxation of Electronic Commerce*, 14 BERKELEY TECH. L.J. 711 (1999); U.S. GOVERNMENT WORKING GROUP ON ELECTRONIC COMMERCE, TOWARDS DIGITAL EQUALITY, SECOND ANNUAL REPORT (1999).
210. Cockfield, *supra* note 4, at 67 (suggesting that Canada and Mexico consider adopting the transfer pricing rules currently in use in the United States).
211. Mann, *supra* note 6, at 226 (explaining how the distinction between "goods" and "services" creates schisms in international trade agreements that are becoming particularly acute when attempts are made to classify an intangible product as either a good or as a service). The distinction is particularly important under the WTO regime because GATT requires signatories to commit to free trade in goods whereas the General Agreement on Trade in Services (GATS) that came into force in 1993 does not require signatories to make any basic or comprehensive commitment to free trade in services.
212. *See generally* JOHN H. JACKSON, THE WORLD TRADING SYSTEM: LAW AND POLICY OF INTERNATIONAL ECONOMIC RELATIONS (1997); Richard N. Snape & Malcolm Bosworth, *Advancing Services Negotiations*, *in* THE WORLD TRADING SYSTEM: CHALLENGES AHEAD (Jeffrey J. Schott ed., 1996).
213. *See* Mann, *supra* note 6, at 227 (U.S. trade representatives recognize that "the complex nature of bundled transactions will create huge problems in classifying these transactions as goods or services, and within services, by which delivery mode").
214. GOVERNMENT OF CANADA, MINISTER'S ADVISORY COMMITTEE ON ELECTRONIC COMMERCE, ELECTRONIC COMMERCE AND CANADA'S TAX ADMINISTRATION: A REPORT TO THE MINISTER OF NATIONAL REVENUE FROM THE MINISTER'S ADVISORY COMMITTEE ON ELECTRONIC COMMERCE, 4.1.1. (1998) (determined that four tasks were absolutely essential to effectively administering an income tax sys-

thorities find it difficult to identify taxpayers in an e-commerce transaction. The lack of reliable identification mechanisms lead to problems for determination of tax liability and undermines efforts to collect the tax from the taxpayer. Very few government controls are in place to govern the electronic transmission and purchase of goods or services. Domain names and Web sites supply little information about the legal entities behind them. Even if an e-mail address can be clearly associated with a certain party, the address does not specify either the physical location of the computer or the identity of the person actually using the computer.

Without appropriate identification mechanisms, it is extremely difficult for governments to trace the productive processes of a digital transaction from the e-commerce vendor through to the end consumer. The ability of Internet users to prevent identification of their e-commerce transactions presents serious practical challenges for tax authorities that need to identify and collect the amount of taxes legally due upon the transaction. National tax authorities need to determine with relative certainty the location and legal identities of e-commerce buyers and sellers. Any future trade agreement must acknowledge the need of national tax authorities to establish the correlative identity of web hosts and taxpayers in e-commerce transactions in order to administer an effective tax system.

*3. Elimination of Intermediaries and the Threat to Tax Collection*

The digital delivery of intangible goods and services acutely undermines the collection of both transaction taxes and income taxes by eliminating or redefining the role of intermediaries. Traditional intermediaries serve as important sources of audit and verification information. The digital revolution has changed the nature of global business. Retailers and financial institutions have historically acted as audit and collection points for national governments. In many sectors private businesses have been conscripted to collect sales taxes from consumers on behalf of the state. Tax authorities rely upon various audit points as sources of information with respect to taxpayers and transactions. These "bricks and mortar" organizations serve as important intermediaries for the collection of transaction taxes.[215] E-commerce circumvents the traditional collection and distribution process. Consumers and businesses can download software or other intangible property directly from the vendor's Web site. Even tangible products ordered online can be shipped directly from the seller's warehouse to the purchaser without the need for further middlemen. The lack of an audit trail in the channels of electronic commerce is particularly troublesome under a self-reporting tax system.[216]

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tem: (1) identification of taxpayer; (2) identification of taxable transactions; (3) proving a link between taxpayer and taxable transactions; and (4) collection of tax from the taxpayer).

215. *See* Forgione, *supra* note 10, at 723-24.

216. North American governments require their taxpayers to accurately report and remit their own income taxes under threat of audit and penalties for default. E-commerce, in itself, undermines the veracity of the government's audit threat.

The elimination of intermediaries in the electronic commerce sales and distribution process has had an acute impact on the sales tax regime of the U.S. states. The tax collection problems currently encountered by state tax authorities is due primarily to the U.S. Supreme Court's interpretation of the constitutional limitation on state and local governments that restricts the imposition of collection responsibility for indirect taxes, such as sales and use taxes, on remote vendors.[217] Although the U.S. Supreme Court dealt with a fact case that involved out-of-state mail order vendors, e-commerce businesses have relied upon the principles established by the Court to avoid the payment of sales tax on Internet sales of tangible and intangible goods and services. State tax authorities have responded by limiting the scope of the physical presence standard and looking to whether the electronic commerce transaction utilizes any intermediary or other device that may have a *situs* in the state, which has led to considerable uncertainty as to whether U.S. state sales and use taxes must be collected by out-of-state e-commerce vendors.[218]

*4. E-Commerce and the Permanent Establishment Concept*

Under the current system of international taxation, the determination of the degree of contact or nexus between an electronic commerce vendor and a state is critical because it ultimately decides the incidence of taxation as well as the jurisdiction to tax the profits derived by the vendor. Domestic laws invariably focus on the nature and the frequency of

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Moreover, the prospect of the use of electronic cash presents another great concern to tax authorities. The absence of financial reporting from intermediaries presents one of the principal challenges to the tax system arising out of e-cash transactions. E-cash potentially removes another audit point and important source of information.

217. *See* National Bella Hess, Inc. v. Dep't of Revenue of Illinois, 386 U.S. 753, 87 S. Ct. 1389 (1967) (where the United State Supreme Court established the physical presence requirement as a prerequisite for state taxation of remote vendors). The substantial nexus test enunciated by the U.S. Supreme Court in *National Bella Hess* was effectively confirmed through a more modern application of the physical presence nexus requirement by the Supreme Court 25 years later in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

218. Quill Corp. was a mail order house with no physical plant or office situated in North Dakota. The State sought to collect its use taxes on products purchased and used by its residents. Even though the United States Supreme Court found that Quill Corp. purposefully directed substantial activities towards residents of North Dakota, the Court held that the safe harbour provisions of the Commerce Clause required a substantial nexus for the imposition of indirect state taxation. *See* Quill Corp. v. N. Dakota, 504 U.S. 298 (1992). Presumably, the application of the physical presence requirement would also apply to remote vendors of e-commerce. Nonetheless, some state courts have been reluctant to apply Quill Corp. beyond its clear facts. Consider Orvis Co. Inc. v. Tax Appeals Tribunal, 654 N.E.2d 954, *cert. denied* 116 S. Ct. 518 (1995) (where two Vermont companies with no physical presence in New York except for several visits by sales representatives were held liable for New York State's use tax). For a review of how state courts appear to be limiting the Supreme Court's physical presence test to state use tax collection of remote mail order vendors, *see* Michael T. Fatale, *State Tax Jurisdiction and the Mythical "Physical Presence" Constitutional Standard*, 54 TAX LAW. 105 (2000).

the business being conducted by the non-resident enterprise.[219] By contrast, the concept of permanent establishment is the prevailing norm for determining tax jurisdiction under the bilateral tax treaty provision dealing with business profits. The treaty criteria of permanent establishment infers a physical presence nexus and disregards the considerations of domestic tax law that focus on the frequency, duration, and significance of the business activities of the foreign entity operating within the country's borders.

Electronic commerce undermines the efficacy of any tax standard based on physical presence. The Internet allows multinational enterprises to conduct regular, frequent, and substantial sales in a foreign country without ever having to establish a fixed base or permanent establishment in the market country. Recent efforts to expand the permanent establishment definition to include Internet servers seem misguided.[220] By focusing on the physical location of the computer server, tax authorities ignore the underlying productive aspects of the e-commerce technology. The most essential mechanism in a digital transaction is not the hardware, but the software that enables the business to conduct its display, sales, and delivery functions. The preoccupation of international tax authorities with the application of a physical standard to an intangible business method sidesteps the need to introduce a new concept that addresses the economic realities of the digital age.[221]

Countries continue to adhere to the permanent establishment concept because it blatantly limits taxation of multinational business profits by the source country. The use of physical presence as the treaty nexus for taxation of global business profits arose as an alternative to the source principles enunciated in the Mexico Draft.[222] Developing countries already

219. Domestic tax authorities must, in the absence of an applicable tax treaty, make determinations of whether an entity is carrying on a business or trade in the jurisdiction.

220. In February, 2001, the OECD—an organization of which Canada, Mexico, and the United States are members—released a report that proposed to include web servers within the treaty definition of permanent establishment by adding paragraph 17 to the Commentary on Article 5 of the OECD Model. *See* OECD, ATTRIBUTIONS OF PROFIT TO A PERMANENT ESTABLISHMENT INVOLVED IN ELECTRONIC COMMERCE TRANSFERS, 42.3-9 (2001). Some OECD countries, notably Spain and Portugal, favored extending the definition of permanent establishment to encompass Web sites and/or local Web servers operated by domestic ISPs on behalf of foreign companies.

221. In contrast to the directives released by the OECD and the tax administrations of many of its members, the Government of India released a report that expressed futility with the notion of pigeonholing e-commerce transactions into the existing definition of permanent establishment. "[T]he concept of [permanent establishment] should be abandoned and a serious attempt should be made within OECD or the U.N. to find an alternative to the concept of [permanent establishment]." INDIA MINISTRY OF FINANCE, REPORT OF THE HIGH POWERED COMMITTEE ON E-COMMERCE AND TAXATION, 12 (2001) [hereinafter INDIA MINISTRY OF FINANCE].

222. The practice of using the definition of "permanent establishment" as the international parameter for business contact was first formulated by the Fiscal Committee of the League of Nations in the 1940s. The definition of permanent establishment was further developed through negotiations of bilateral treaties and was crystallized in the OECD Draft Model Convention of 1963. U.N. DEPARTMENT OF IN-

argue that the current network of bilateral tax treaties are biased against them.[223] As e-commerce transactions become more substantial, the revenue losses suffered by the source or market country will escalate with the continued use of prevailing permanent establishment rules. The poorest countries of the world will be the ones that will tend to incur the greatest losses as a result of the continued use of the permanent establishment concept.[224]

## V. THE INTEGRATIVE TASK OF WEAVING A CONTINENTAL TRADE WEB

NAFTA is predicated on a continental web of interdependent principles and objectives.[225] The Free Trade Agreement strives to promote mutuality of benefits for all parties through harmonized rules dealing with tangible and intangible goods and services.[226] Electronic commerce provides a mechanism for moving economic activity closer to some of the ideals of perfect competition, including low transaction costs, reduced barriers to entry, improved consumer access to information, and elimination of time and distance as barriers to trade.[227] While electronic commerce successfully complements many elements of international trade, it also creates new problems never previously encountered or envisaged by free trade negotiators.

NAFTA needs to respond to the challenges of the digital age by implementing a series of reforms. The NAFTA Member States must start by acknowledging the need for greater tax policy coordination, particularly in connection with electronic commerce. As the first decade of NAFTA

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TERNATIONAL ECONOMICS & SOCIAL AFFAIRS, GUIDELINES FOR TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, 14 (1974).

223. *See* Forgione, *supra* note 10, at 761-64.

224. In so far as most large multinational corporations and major capital owners are resident or based in developed or industrialized countries, the shift from source country taxation of income to residence country taxation of income will correspondingly lead to a transfer or foregoing of revenues from capital-importing countries to capital-exporting nations. Tax authorities in India recently confirmed that the application of the permanent establishment norm in an e-commerce environment "does not ensure certainty of tax burden and maintenance of the existing equilibrium in sharing of tax revenues between countries of residence and source". INDIA MINISTRY OF FINANCE, *supra* note 221, at 11.

225. NAFTA promotes the concepts of mutual advantage and harmonization of treatment as fundamental components of the reciprocal trade relations of the signatories to the Free Trade Agreement. The Preamble to NAFTA states that the Parties to the Agreement are resolved to, among other things: "Establish clear and mutually advantageous rules governing their trade; Ensure a predictable commercial framework for business planning and investment." NAFTA, *supra* note 1.

226. The FTAA may strive for the same objectives as NAFTA, but it would be presumptuous to believe that the FTAA can promise the same level of integration for goods and services currently enjoyed under NAFTA. Consider, "A major element of the trade agenda for the next decade will be the task of extending the world trading regime beyond trade in goods to include trade in services, trade-related investment issues, and the mushrooming information sector." Cunningham, *supra* note 180, at 384.

227. Willingham, *supra* note 5, at 487.

comes to a close, there is increasing evidence that the interconnectedness of the trade and capital markets governed by NAFTA will exploit the deficiencies and expose the differences of the respective tax regimes of the Member States.[228] The lack of harmonization of taxation measures amongst Canada, Mexico, and the United States will undoubtedly present administrative difficulties, avoidance opportunities, and establish artificial biases that could potentially counteract the trade liberalization features of the Free Trade Agreement. NAFTA should introduce a framework that establishes basic taxation principles for the treatment of international trade and investment income. This first step would involve the extension of the trade principles of National Treatment and Most Favored Nation Treatment to tax measures.[229] The underlying objective of integrating a general tax framework into the Free Trade Agreement would be the furtherance of the principles of mutual gain and harmonization of treatment espoused throughout NAFTA.

The next move towards integration of tax and trade policies within NAFTA involves recognition of the need to reduce reliance on bilateral tax treaties involving two Member States. Tax revenues represent one of the most important benefits a nation receives from foreign investment and trade within its territory. Unlike NAFTA, bilateral tax treaties do not purport to pursue mutual advantage for its contracting parties. Nations are naturally motivated by revenue interests and other concerns when negotiating a bilateral treaty, and accordingly, treaty partners should not be expected to agree upon the most mutually advantageous treaty provision.[230] The allocation of tax jurisdiction in a bilateral treaty constitutes a fiscal transfer mechanism between nations. The assignment of primary tax jurisdiction to one country will result in the loss of tax revenue to the other treaty partner. In practice, bilateral tax treaties not only upset the pre-treaty equilibrium of shared tax revenues, they shift the fiscal balance in favour of the more economically advanced treaty partner. The existing scheme of most bilateral tax treaties gives rise to the anomalous result of tax revenues flowing from capital-importing countries, such as Mexico, to capital-exporting countries, such as the United States.

The growth of electronic commerce serves to exacerbate the shortcomings of prevailing tax treaty norms. Any substantive move towards tax

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228. *See* Cockfield, *supra* note 4, at 69 (arguing that the "adoption of more comprehensive measures, including some tax uniformity among the Member States, will thus become a more attractive alternative in the long term.").

229. Some sections of NAFTA already make reference to the extension of National Treatment provisions to certain tax measures, such as in respect of the performance of cross-border services. *See* NAFTA, *supra* note 1, article 2103(4)(a).

230. The negotiation of bilateral tax treaty provisions appears not to be motivated by any principle of mutual gain as much as it is driven by the fiscal demands of taxing nations. Where income is derived by a resident of one country from sources in a foreign country, and if both countries assert a legitimate claim to tax that income, then either country may view an agreement to grant the other the primary right to tax that income as a loss of tax revenue.

integration within NAFTA should be accompanied by international tax reforms. Trading nations must recognize that the fiscal losses incurred by e-commerce market countries are likely to contribute to greater technological disparity unless properly addressed through a series of trade and tax reforms.[231] If the digital divide in North America is to be bridged, the integration of tax rules into NAFTA should ensure that new tax norms allow source or market countries to reap some of the fiscal benefits of electronic commerce and foreign investment.

The integration of tax rules into a multilateral trade, investment, and tax agreement involving Canada, Mexico, and the United States would go a long way towards resolving the NAFTA objective of harmonization of treatment. Multilateral trade pacts purport to adopt a holistic approach that may effectively bridge the disparity of economic relations between developed and developing countries. The implementation of tax measures in a multilateral trade agreement infers the abandonment of the bilateral tax conventions between NAFTA parties. The move towards multilateral tax agreements represents the natural evolution of international tax reforms. Bilateral tax treaties are dinosaurs in an age where increasingly greater emphasis is placed on multilateral agreements.[232] Bilateral treaty negotiations are not conducive to the adoption of uniform and harmonious rules involving more than two parties.[233]

The continental Free Trade Agreement should compel North American governments to treat e-commerce transactions in the same manner as conventional commerce.[234] At its most basic level, NAFTA could bring e-commerce within its fold by declaring that purely digital transactions are to be treated akin to sales and transfers of tangible goods and services. However, the key to adopting a uniform approach in NAFTA towards e-commerce will depend on whether such a declaration is accompanied by tax measures designed to accommodate the fiscal inter-

231. Severe technological disparities between the countries of the Americas currently represents a huge impediment to continental trade and the disparity is expected to escalate unless addressed. "By the time the FTAA is formed in 2005, the Internet will be far advanced and electronic commerce will be far more important than it is today [but developing countries'] lack of technology creates a barrier to trade in the global marketplace and will hamper the growth towards true global electronic commerce." Willingham, *supra* note 5, at 507.

232. "In many ways, tax treaties are like dinosaurs in the modern world of international trade. They are bilateral in a world of multilateral trade agreements, and they take just short of forever to conclude." Mitchell, *supra* note 58, at 210.

233. The analysis of the pertinent tax conventions of the NAFTA Member States set out in this article supports the proposition that bilateral tax treaties often fail to provide congruence with the objectives of multilateral trade agreements. Even though negotiations in respect of the Canada-Mexico Convention, the U.S.-Mexico Convention and certain parts of the Canada-U.S. Convention took place within a short time period, there is alarming diversity among these conventions in respect of the treatment accorded certain types of income.

234. *See* Graetz, *supra* note 112, at 1363 (noting that international tax neutrality is an essential feature of government domestic and foreign policies because of its promotion of worldwide economic efficiencies). Forgione, *supra* note 10, at 746-47 (arguing that international tax principles require authorities to treat e-commerce transactions in the same manner as conventional business transactions).

ests of the least technologically advanced of the Member States, namely, Mexico. Any realistic accommodation of electronic commerce would involve the abandonment of the permanent establishment concept as the nexus for income taxation.[235] The adoption of a market or consumption based standard for taxation of e-commerce transactions would likely moderate the tax revenue equilibrium within North America.[236]

The gradual integration of tax rules into NAFTA will enhance the benefits of liberalized trade and promote the objectives of mutual gain and harmonization of treatment proclaimed by the Free Trade Agreement. The gradual integration of tax rules under the auspices of a comprehensive and multilateral North American Free Trade Agreement at first blush appears to challenge the notion of the tax sovereignty. The reality, though, is that tax integration does not necessarily detract from the fiscal independence of NAFTA's Member States any differently that the interact of the trade pact and commercial laws enacted by states, provinces and regions. If the NAFTA Member States are concerned about the national sovereignty implications of pursuing an effective tax integration strategy, then it is possible for sovereignty concerns to be addressed by assurances that tax rates, subnational taxation and special tax measures will be excluded from the extension of the integrative scope of NAFTA.

The practical reality of the NAFTA countries concluding a multilateral tax arrangement satisfactory to each of them will be influenced by a variety of factors. The issue of resolving tax claims and entitlements to tax revenues may be the most contentious of all issues and the most difficult to resolve.[237] The key issue might come down to whether the United

235. To reiterate the argument, bilateral tax treaties restrict the jurisdiction of the source country to tax income derived by foreign e-commerce vendors by stipulating that a sufficient nexus must be established in order to permit taxation in the source country. So, if an e-commerce business resident in the United States makes digital sales to Mexican buyers without establishing a permanent establishment in Mexico, then according to the Mexico-U.S. tax treaty, the Mexico government will be precluded from taxing the income of the U.S. enterprise derived from its sales into Mexico. In the absence of the tax treaty, the U.S. enterprise would be subject to taxation in Mexico on the income that it derived from its Mexican sales. The tax treaty provision for taxing the business profits of a foreign enterprise represents a negotiated departure from the status quo established under domestic tax rules. It is possible to insert text in NAFTA that establishes a nexus for the taxation of business profits within North America that is distinct from the treaty norm of permanent establishment and the respective domestic standards of each Member State.

236. Government officials may have to consider the possibility that clauses in existing tax conventions involving non-NAFTA treaty partners could require reciprocity. For instance, the existence of a Most-Favored Nation Treatment provision in a bilateral tax convention involving a Member State could lead to the extension of the NAFTA tax treatment of e-commerce (such as, the proposed abandonment of the permanent establishment definition) to non-NAFTA partners. In such instances, tax authorities may have to consider the viability of renegotiation of non-NAFTA tax treaties.

237. It may mean abandoning treaty provisions that are skewered in favour of capital-exporting nations and replacing them with new measures that ensure that all countries receive an equitable share of tax revenues and other benefits from international trade and investment. Increased source country taxation and high

States Treasury is prepared to forego any gained advantage under the bilateral tax treaties in order to become a party to a multilateral agreement that would encourage freer trade in a wide array of goods and services, including digital products. The United States may be willing to consider an integrated tax and trade arrangement if it believes that a multilateral tax convention will further the U.S. policy objective of global trade liberalization and promote the basic tenets of NAFTA.[238]

NAFTA was heralded as the beginning of a new era of economic cooperation and trade amongst nations. The Free Trade Agreement of the Americas presents a further window of opportunity to achieve goals that were previously considered unattainable. However, in order for the less developed countries of the South to engage in fair and mutually rewarding trade with the wealthy nations of the North, it will be necessary to discard the tax rules and norms that act as barriers to economic development. A multilateral tax treaty could be formulated utilizing prevailing treaty norms with modifications that promote the objectives of the underlying trade agreement.[239] Such a multilateral tax agreement would have the immediate benefit of harmonization and, depending on the determination of the rates of withholding tax and the ratio or formula for apportionment of business profits the agreement could also further the objective of mutual advantage. The web of complex integrated tax and trade rules will not be easy to weave, but the promise of free trade across the World Wide Web should undoubtedly inspire the process.

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withholding tax rates could, in turn, serve as impediments to free trade. The key would be to attain a balance that recognizes the importance of tax neutrality and applies capital-import neutrality principles to certain income sources such as the taxation of active business income and capital-export neutrality principles to other forms of income (such as in respect of the taxation of cross-border royalty payments).

238. The potential for U.S. economic dominance of the hemispheric free trade agenda is a real concern. *See* Guy Poitras, *The Potential for U.S. Economic Dominance*, 6 NAFTA: L. & Bus. Rev. Am. 389 (2000) (noting that the United States has long championed a Pan American vision of a liberal, democratic capitalist hemisphere based on the principles of economic unity and integration). The role of the United States in NAFTA, while still huge and hegemonic, may be more open to acceptance of tax integration within an inclusive e-commerce framework. The United States would probably also be inclined to use the opportunity of a separate NAFTA taxation agreement to promote its transfer pricing rules and, possibly, to open the door to the development of a formulary apportionment system for international income.

239. The residence country bias of the existing treaty network can be modified by adjusting the rates of withholding tax and the apportionment formula to increase the flow of revenues to poor countries. In order for a multilateral tax treaty to succeed, the governing principle in the negotiation process must be the fair sharing of international income tax revenues. The establishment of a multilateral tax treaty binding all of the parties to NAFTA would establish consistent sourcing rules, a unified set of withholding rates, and hopefully, clear and equitable roles for apportioning the commercial profits of multinational enterprises.