Domestic Taxation Measures as Trade Subsidies & Tariffs: Considerations for NAFTA Renegotiation

Nicholas dePencier Wright

Osgoode Hall Law School of York University
LLM in Taxation
International Tax 6739
Professors Jinyan Li and Scott Wilkie
April 2017

TABLE OF CONTENTS

1. NAFTA Controversy

The *North American Free Trade Agreement* (**"NAFTA"**)[1] is a tripartite free trade agreement signed by Canada, the United States of America (**"US"**) and Mexico on December 17, 1992, subsequently ratified by each nation's parliament/legislature and implemented on January 1, 1994. For Canada and the US it replaced the 1988 *Canada–United States Free Trade Agreement*.[2] Because most Canada-US trade was already duty free, for Canada and the US, NAFTA primarily eliminated some non-tariff trade barriers and further protected intellectual property rights. The impact for trade-relations with Mexico was more significant as NAFTA additionally phased out the many existing tariffs. NAFTA was meant to address trade barriers between nations rather than impose upon domestic policy. Consequently, there are a number of exemptions to the application of NAFTA including an exemption for most non-duty taxation measures.

NAFTA has always been controversial. There were and are significant concerns about environmental and labour issues.[3] Opponents to NAFTA feared that the agreement would create a race to the bottom where the country with the weakest environmental and labour laws would thrive, forcing other countries to abandon their more stringent policies. In an attempt to address these concerns the *North American Agreement on Labor Cooperation* (**"NAALC"**)[4] and the *North American Agreement on Environmental Cooperation* (**"NAAEC"**)[5] were implemented as a side agreements. Each created a body to oversee common environmental and labour standards among the countries. What was not meaningfully discussed and what remains an open issue, however, is the extent to which different systems of domestic taxation are permitted to act as trade subsidies, relying upon NAFTA's exemption for domestic taxation.

The November 8, 2016 election of US President Donald Trump, in part due to his campaign promises to renegotiate NAFTA and to bring back jobs to the US, has reopened discussions regarding the effectiveness of NAFTA and areas for amendment and improvement. This paper will provide existing and proposed examples of ostensibly domestic tax provisions in Canada and the US that arguably have the effect of subsidizing international trade and will argue that to achieve the NAFTA objectives of fair competition and free trade, such indirect subsidies should be explicitly restricted. Prime examples of such domestic tax measures are the Canada and US policies that allow for a significant reduction of tax liability for goods and services sold abroad through foreign subsidiaries. By way of example, we will outline how the Canadian foreign affiliate rules subsidize Canadian international business with domestic tax credits, deductions and exemptions.

2. Canadian Foreign Affiliate Rules

The Canadian foreign affiliate rules govern the taxation of foreign corporations that have ties to Canadian residents. Firstly, the foreign accrual property income (**"FAPI"**) rules seek to prevent the deferral of the taxation of passive income (e.g. royalties, rents, interest, and non-foreign affiliate dividends) from foreign affiliates by imposing tax on FAPI on Canadian resident shareholders when the income is earned rather than upon distribution. Secondly, the rules address the treatment of dividends received by Canadian resident shareholders from foreign affiliates paid out of earnings generated from active business (i.e. everything that is not passive, e.g. manufacturing and transportation). When earnings arise from active business in a county that Canada has entered into a tax treaty and/or tax information exchange agreement with, such dividends from active income can be characterized as "exempt surplus" and be received by the Canadian resident shareholder free of any Canadian tax.[6] This is particularly significant when the foreign country is a low-tax jurisdiction such as Barbados or the Cayman islands and the tax paid in the foreign jurisdiction is nominal or non-existent.

In addition to the broad exemption from Canadian income tax for eligible profits on international business and trade, provisions of the *Income Tax Act* (**"Act"**)[7] additionally provide favourable domestic tax treatment for financing, selling shares in and withdrawing capital from controlled foreign affiliates. Notably, section 20(1)(c) of the Act allows for the deduction of interest expenses incurred when borrowing to invest in a foreign affiliate and section 17(1) of the Act allows for a Canadian taxpayer to make an interest free loan to a controlled foreign affiliate without imputed interest income so long as the funds are used to earn *active* business income.[8] This permits investment free from both the domestic taxation of loan interest and domestic income taxation on profits generated by the investment when they are repatriated to Canada tax free as exempt surplus. Under Section 113(1) of the Act, a distribution from a foreign affiliate may also be characterized either as a dividend; or, as a return of capital – which is generally not included in the recipient's income. This means that an investor can receive a payment from a foreign affiliate without incurring taxes when it would otherwise be a taxable dividend out of the foreign affiliate's taxable surplus account (in contrast to the exempt surplus account). The foreign affiliate "Hybrid Surplus" regime also ensures that capital gains on the disposition of shares in foreign affiliates are not taxed at a greater rate than if the gain was earned domestically in Canada.[9] These provisions provide generous tax savings for those investing in and conducting active international business through a foreign affiliate.

The Canadian foreign affiliate rules have been the subject of debate.[10] In 1992 the Auditor General of Canada expressed concern noting that the foreign affiliate rules were significantly eroding the Canadian tax base.[11] In response, the government stated that, "the existing foreign affiliate regime accurately reflects the policy intention of Parliament and provides for the taxation of all income that is intended to be subject to Canadian income tax."[12] Clearly, the Federal government has chosen to substantively maintain the status quo with respect the foreign affiliates despite the resulting and increasing loss in tax revenues to the benefit of certain Canadian international business and trade. The US, which also exempts certain foreign subsidiary generated income from domestic taxation using different rules, has in recent years taken domestic policy as trade subsidy one step further. It has done so by promoting a more aggressive tax policy that attempts to walk a fine line between trade neutral domestic tax policy and prohibited subsidies and tariffs.

3. Proposed US Border Adjustment Tax

In a 2016 policy document entitled "A Better Way — Our Vision for a Confident America,"[13] the US Republican Party proposed the implementation of a border adjustment tax which taxes imports but exempts exports within the confines of the existing but "transformed"[14] business tax system. According to US economist Alan J. Auerbach, the initial proponent for such a tax, a border adjustment tax is *not* a tariff and does not distort international trade (or domestic consumption) because, coupling an import tax with an export exemption (by way of rebate or deduction of international sales from taxable income) will be offset by an immediate adjustment in exchange rates. Dr. Auerbach argues that the benefits of such a destination based corporate tax would eliminate incentives to manipulate transfer prices to shift profits and to move operations to lower tax jurisdictions to take advantage of lower tax rates in foreign jurisdictions.[15] While Dr. Auerbach's argument for the trade neutrality of a border adjustment tax may be compelling in theory and in isolation, in practice, it is improbable that no other tax, trade or currency factors would interfere with the theoretical balancing of currencies to negate trade distortions. Dr. Auerbach acknowledges this when he states that:

> It should also be stressed that this neutrality with respect to trade applies to border adjustments specifically, but not necessarily to a broader change in the tax system. This is an especially important caveat in the context of current US tax proposals. For example, if the US were to adopt a tax system that encourages saving relative to consumption, the resulting weakening of demand for imported consumer goods could well improve the US trade balance. But this would be a consequence of the change in the incentive to save, not because of the border adjustments.

Just how a border adjustment tax in practice (and in relation to real word tax and economic factors) might distort trade is contentious. Notably, while Republican President

Donald Trump appears to accept the proposal stating that "[i]t could lead to a lot more jobs in the US,"[16] Canadian commentary has been widely mixed, asserting that it will be good for Canada, that it will be bad for Canada and that it will be bad for both Canada and the US.[17]

While the proposed US border adjustment tax is framed as a trade neutral transformation of the existing business tax system, potential World Trade Organization (**"WTO"**) and NAFTA implications are real. Dr. Auerbach addresses this point asserting that WTO (and by implication NAFTA) compliance is "an open question" because the border adjustment tax could be found to be a prohibited direct tax on imports and to be impermissibly favouring domestic production.[18] On its face, the border adjustment tax penalizes importers and subsidizes exporters while using uncertainty about the application of economic theory in practice as a cloak to argue compliance with international free trade agreements. Whatever the consequence of such a tax would be, there is no doubt that it is an appealing solution for those seeking to implement protectionist trade policies while asserting trade agreement compliance.

The common question raised in examining the Canadian foreign affiliate rules and the proposed US border adjustment tax are whether such policies are features of existing (if amended) domestic tax policy exempt under NAFTA or prohibited trade subsidy. We will now examine the application of NAFTA and WTO rules.

4. Applicability of NAFTA & WTO Prohibitions & Exemptions

While the specifics on timelines and exemptions in NAFTA are somewhat complex, the broad principles that that the agreement seeks to promote are not. NAFTA seeks to:

a) Eliminate barriers to trade in, and facilitate the cross-border movement of, goods and services between the territories of the Parties;

b) Promote conditions of fair competition in the free trade area;

c) Increase substantially investment opportunities in the territories of the Parties;

d) Provide adequate and effective protection and enforcement of intellectual property rights in each Party's territory;

e) Create effective procedures for the implementation and application of this Agreement, for its joint administration and for the resolution of disputes; and,

f) Establish a framework for further trilateral, regional and multilateral cooperation to expand and enhance the benefits of this Agreement.[19]

In furtherance of these objectives NAFTA Part 2, Section B, Article 302 states that (except as otherwise provided in the agreement) existing customs duties may not be increased and were required to be progressively eliminated as outlined in Annex 302.2.

With respect to direct taxation (taxes paid directly to a government by an individual or organization, such as income tax, and not indirectly through taxing the manufacture or sale of goods or services, such as sales tax), NAFTA Part 5, Chapter 12 states that each party to the agreement must treat the other parties no less favourably than either its own providers or any other third party (NAFTA signatory or otherwise).

Notably, however, the broad provisions in Chapter 12 are significantly narrowed with respect to taxation (in contrast to tariffs – an explicit indirect tax levied on specific goods when they cross a border). NAFTA Part 8, Chapter 21, Article 2103 states that the agreement does not apply to taxation measures except as specifically provided for in the agreement (with few such provisions), that tax treaties take priority over NAFTA provisions when they conflict, and that NAFTA shall not affect the rights or obligations of any party under a tax convention.[20] Clearly when it comes to taxation, NAFTA is subordinate to other tax treaties and conventions. But NAFTA is not the only applicable international trade agreement binding NAFTA member countries.

The General Agreement on Trade and Tariffs (**"GATT"**),[21] first signed in 1947, the General Agreement on Trade in Services (**"GATS"**)[22] and the Agreement on Subsidies and Countervailing Measures (**"SCM Agreement"**),[23] both signed in 1995, and all now under the auspices of the WTO, also apply to the NAFTA signatories. Like NAFTA, these agreements place restrictions on protective trade measures. GATT, for example, places prohibitions on raising tariffs. It also prohibits differential treatment of goods based on nation of origin. GATT Article III speaks to taxation stating that taxes should not be levied on imported or domestic products to protect domestic production and that foreign and domestic products should be equally taxed. Because GATT rules on import barriers deal with goods, it was historically the view that GATT does not apply to direct taxation because goods and direct taxes are insufficiently connected. Recent GATT panel decisions (and the signing of GATS and the SCM Agreement) have overturned this line of thinking, however, and have focused increased attention on the impact of domestic tax measures on trade. This modern focus on the impact of domestic taxation on trade has resulted in an increase in WTO direct tax disputes, including a notable dispute brought forward by the European community against the US regarding US corporate tax policy.[24]

In 1984 the US enacted the United States Foreign Sales Corporation (**"FSC"**) tax measure that sought to address perceived tax disadvantages for US exporters by providing tax exemptions for export income. The European community argued that the policy was a violation of the SCM Agreement because it conferred an unfair benefit on US domestic producers. The US argued that the provision was analogous to permissible territorial taxation (limiting the levying of a tax to a particular territorial region) and that the SCM Agreement did not require the domestic taxation of "foreign economic processes." In October 1999 a WTO panel found against the US, rejecting its argument that the policy was analogous to non-taxation of foreign economic processes while upholding the principle. The US appealed and in 2000 the appellant body again ruled against the US. After additional dispute regarding US compliance with the ruling and the implementation of sanctions against the US, the FSC was repealed in 2004 as part of the *American Jobs Creation Act*.[25]

While a detailed analysis of the applicability and interpretation of WTO trade agreements is outside of the scope of this paper, a broad overview of NAFTA and WTO provisions and the twenty year timeline for the FSC dispute demonstrates that there can be significant room for debate and disagreement over whether a tax is a permissible and exempt domestic tax measure or a international trade subsidy or tariff in disguise.

Furthermore, seeking a remedy for an alleged breach can be a long and arduous process. The appeal is then clear for governments not inherently sold on the domestic benefits of multilateral international free trade to attempt to get around international obligation with domestic policy. Such an approach is a politically expedient way to show support both for proponents of international free trade and of domestic protectionism while claiming compliance with international obligations, all the while knowing that if challenged, it could well be a future administration – or two – dealing with issue. Having identified examples of domestic policy as trade subsidy and provided an overview of the applicability of NAFTA and WTO rules, we will now consider the proposed renegotiation of NAFTA and the opportunity it creates to remedy existing shortcomings.

5. Implications for NAFTA Renegotiation

Both during the presidential campaign and since his inauguration on January 20, 2017, US President Donald Trump has repeatedly made bombastic statements about NAFTA, the problems it has caused and his intention to either renegotiate or terminate the agreement. Trump has asserted that NAFTA "has been a catastrophic trade deal for the United States," that has "been very, very bad for our companies and for our workers." He has also characterized it as "one of the worst deals ever made by any country, having to do with economic development," vowing to "either renegotiate it or… terminate it."[26] Most recently, after speaking with each of Canadian Prime Minister Justin Trudeau and Mexican President Enrique Peña Nieto, President Trump has stated that he wishes to work to renegotiate the agreement rather than terminate it.[27] Despite the political theatrics and hyperbole, to date the only substantive information provided has been a leaked draft letter to the US Senate and House[28] listing a series of modest adjustments to the agreement including to "seek to level the playing field on tax treatment" and a less informative one page draft Executive Order to withdraw from NAFTA blaming the agreement for lost US jobs and economic plight.[29] The draft Order was quickly countered by President Trump's public vow to instead renegotiate. The take-away from political events to date is that NAFTA provisions will be re-considered by all three countries and that, based on the leaked draft letter, the changes can be expected to be adjustments rather than a major overhaul. This provides a rare and important opportunity to introduce provisions into NAFTA that identify and address the use of domestic tax measures as international trade subsidies or tariffs.

Provisions should be added to NAFTA to define and differentiate between exempted domestic tax policy consistent with NAFTA principles and domestic tax policy that seeks to surreptitiously act as an otherwise prohibited subsidy or tariff. Doing so will provide increased clarity, lessen government incentive to implement trade distorting policies and assist in furthering the NAFTA goals of increasing trade and investment throughout North America. Specifically, to address the issues raised, NAFTA should be amended to:

- **a)** Define domestic tax measures used as subsidy or tariff;
- **b)** Prohibit new domestic tax measures used as subsidy or tariff;
- **c)** Set an elimination date for all domestic tax measures used as subsidy or tariff;
- **d)** Create a schedule of existing domestic tax measures used as subsidy or tariff that will remain or be phased out on a special timeline, if applicable and required to bring about agreement between the parties;

e) Provide that the removal of domestic tax measures used as subsidy or tariff shall, unless otherwise stated the schedule, take precedence over other tax treaties, conventions and agreements.

By implementing the above recommendations, NAFTA can be amended to further its purpose of facilitating free trade by eliminating indirect trade subsidies and tariffs.

6. NAFTA Should Restrict Tax Measure Trade Subsidies & Tariffs

NAFTA, though controversial, has promoted trade between member countries by removing tariffs, prohibiting trade subsidies and by providing a framework for collaboration and discussion. The US, after its most recent election, has expressed a desire to revisit the terms of NAFTA in an attempt to make sure that it is serving its economic interests. A draft letter to the US Senate and House suggests that, despite political theatrics and hyperbole, the proposed amendments are specific adjustments and do not constitute a structural overhaul. Notably, the draft letter identifies leveling tax treatment between nations as an objective. NAFTA renegotiation provides an opportunity to address a significant and to date unaddressed issue — the use of NAFTA exempt domestic trade measures to indirectly implement subsidies and tariffs that would be prohibited if implemented directly. By defining and identifying such policies, committing to phase them out and giving NAFTA authority over competing arrangements on a reasonable timeline, this major issue with NAFTA can be addressed and its principles of advancing free trade and cooperation across North America can be advanced.

7. End Notes

[1] North American Free Trade Agreement (NAFTA) <http://international.gc.ca/trade-commerce/trade-agreements-accords-commerciaux/agr-acc/nafta-alena/fta-ale/index.aspx?lang=eng>. Accessed April 10, 2017.

[2] Canada–United States Free Trade Agreement (1988). <http://international.gc.ca/trade-commerce/assets/pdfs/agreements-accords/cusfta-e.pdf>. Accessed April 10, 2017.

[3] For example see: "Canada is trading away its environmental rights." David Suzuki Foundation. January 29, 2015 <http://www.davidsuzuki.org/blogs/science-matters/2015/01/canada-is-trading-away-its-environmental-rights/> and "On NAFTA, Trudeau must protect public services, workers and our environment." Canadian Union of Public Employees. February 1, 2017. <https://cupe.ca/nafta-trudeau-must-protect-public-services-workers-and-our-environment>.

[4] North American Agreement on Labor Cooperation (NAALC) <https://www.canada.ca/en/employment-social-development/services/labour-relations/international/agreements/naalc.html>. Accessed April 10, 2017.

[5] North American Agreement on Environmental Cooperation (NAAEC) <http://www.cec.org/about-us/NAAEC>. Accessed April 10, 2017.

[6] Canada's Foreign Affiliate Rules: A Decade of Proposals Nearing Completion. Osler. October 31, 2012. <https://www.osler.com/en/resources/cross-border/2012/canada-s-foreign-affiliate-rules-a-decade-of-prop>. Accessed April 25, 2017.

[7] *Income Tax Act*, RSC 1985, c 1 (5th Supp).

[8] Randy S. Morphy, "The Modern Approach to Statutory Interpretation" (2013) 61:2 *Canadian Tax Journal* 367-385.

[9] Osler. *Supra*.

[10] Nicholas dePencier Wright. "Canada Barbados Tax Treaty: Controversy & Proposed Reform." December 2016. <http://www.wrightbusinesslaw.ca/wp-content/uploads/2016/12/Nick-Wright-Canada-Barbados-Tax-Treaty-Controversy-Proposed-Reform-161228.pdf>. Accessed April 27, 2017. Page 10.

[11] Office of the Auditor General of Canada. "1992 Report of the Auditor General of Canada." Chapter 2. <https://web.archive.org/web/20140304084745/http://www.oag-bvg.gc.ca/internet/English/parl_oag_199212_02_e_8055.html#0.2.L39QK2.V0OCQD.CS3YFE.F1>. Accessed April 27, 2017. As cited in Wright. *Supra*.

[12] Office of the Auditor General of Canada. "2002 December Report of the Auditor General." <http://www.oag-

bvg.gc.ca/internet/English/parl_oag_200212_11_e_12405.html> Accessed April 27, 2017. As cited in Wright. *Supra*.

[13] "A Better Way — Our Vision for a Confident America." Republican Party (United States). <https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf>. June 24, 2016. Retrieved April 11, 2017.

[14] *Ibid*. Page 27. Para 5.

[15] Alan J. Auerbach, Holtz-Eakin, Douglas. "The Role of Border Adjustments in International Taxation." November 30, 2016. <https://www.americanactionforum.org/wp-content/uploads/2016/11/The-Role-of-Border-Adjustments-in-International-Taxation.pdf>. Accessed April 11, 2017.

[16] Steve Holland. "Exclusive: Trump says Republican border tax could boost U.S. jobs." Reuters News Agency. <http://www.reuters.com/article/us-usa-trump-tax-exclusive-idUSKBN1622J5>. Accessed April 11, 2017.

[17] See: Jesse Ferras. "How Canada could fight back against a 20% U.S. border tax." Global News. February 7, 2017. <http://globalnews.ca/news/3234323/us-border-tax-canada-economy/>. Accessed April 11, 2017; Trevor Tombe. "Worried abut the U.S. border-adjustment tax? It might actually help Canada." Financial Post. March 1, 2017. <http://business.financialpost.com/fp-comment/trevor-tombe-worried-about-the-u-s-border-adjustment-tax-it-might-actually-help-canada>. Accessed April 11, 2017; and, Andy Blatchford. "Border tax may be more harmful to U.S. economy than Canada's: Morneau." The Canadian Press. April 3, 2017. <http://www.theglobeandmail.com/news/politics/border-tax-might-damage-american-economy-more-than-canadas-morneau/article34561368/>. Accessed April 22, 2017.

[18] Auerbach. *Supra*. Page 14. Para. 4.

[19] North American Free Trade Agreement. Government of Canada. Part 1, Chapter 1, Article 102. <http://international.gc.ca/trade-commerce/trade-agreements-accords-commerciaux/agr-acc/nafta-alena/fta-ale/01.aspx?lang=eng>. Accessed April 29, 2017.

[20] NAFTA and Taxation. Legal Centre for Business & Technology. University of Calgary. <https://www.ucalgary.ca/biztechlaw/node/290>. Accessed April 29, 2017.

[21] General Agreement on Trade and Tariffs 1994. World Trade Organization. <https://www.wto.org/english/docs_e/legal_e/legal_e.htm>. Accessed April 29, 2017.

[22] General Agreement on Trade in Services 1995. World Trade Organization. <https://www.wto.org/english/tratop_e/serv_e/gatsintr_e.htm>. Accessed April 29, 2017.

[23] Agreement on Subsidies and Countervailing Measures 1995. World Trade Organization. <https://www.wto.org/english/docs_e/legal_e/24-scm.pdf>. Accessed April 29, 2017.

[24] Michael Daly. The WTO and Direct Taxation. World Trade Organization. June 2005. <https://www.wto.org/english/res_e/booksp_e/discussion_papers9_e.pdf>. Accessed April 29, 2017. Pages 4-8.

[25] *Ibid*. Pages 9-11.

[26] Meera Jagannathan. "Here are all the terrible things President Trump has said about NAFTA — before deciding to stick with it." New York Daily News. April 27, 2017. <http://www.nydailynews.com/news/politics/terrible-president-trump-nafta-article-1.3107104>. Accessed April 29, 2017.

[27] Trump said he was serious about withdrawing from NAFTA, but then Trudeau called. And the Mexican president called. Daniel Dale & Bruce Campion Smith. <https://www.thestar.com/news/world/2017/04/27/trump-just-said-he-was-serious-about-withdrawing-from-nafta-but-then-trudeau-called.html>. Accessed April 29, 2017.

[28] Draft NAFTA Letter to United States Senate/House of Representatives. Leaked April 5, 2017. <https://home.kpmg.com/content/dam/kpmg/us/pdf/2017/03/tnf-draft-nafta-letter.pdf> Accessed April 29, 2017.

[29] Draft NAFTA Executive Order Notice of Withdrawal from NAFT. Leaked April 28, 2017. <http://im.ft-static.com/content/images/19e3b522-2c57-11e7-9ec8-168383da43b7.img>. Accessed April 29, 2017.

8. Author Information

Nicholas dePencier Wright. Wright Business Law, Toronto. BA (2000) King's College, Halifax; JD (2007) Dalhousie; MBA (2007) Dalhousie; LLM Taxation candidate at Osgoode Hall Law School, York University. Email: nick@wrightbusinesslaw.ca.

9. Bibliographical Information

Nicholas dePencier Wright "Domestic Taxation Measures as Trade Subsidies & Tariffs: Considerations for NAFTA Renegotiation" (Toronto: 2017).