North American Free Trade & Investment Report

WorldTrade Executive, Inc.

Biweekly report on legal & financial issues affecting direct investment and cross-border trade in Mexico, the U.S., and Canada

Canada: Investment

Significant Changes to Canadian Competition and Foreign Investment Laws Proposed

By Mark Katz and Jim Dinning
(Davies Ward Phillips & Vineberg LLP)

On February 6, 2009, the Canadian government followed through on its promise to propose significant changes to Canada's *Competition Act* and *Investment Canada Act* by introducing Bill C-10, the *Budget Implementation Act, 2009* (the "Bill"). (See the January 31, 2009 edition of *NAFTIR* for a related report.)

Among the Bill's numerous provisions are proposals to:

- replace the existing conspiracy provisions in the *Competition Act* with a *per se* criminal offence for cartel-like agreements between

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Mexico: Taxation

Calculating Corporate Estimated Income Tax Payments in Mexico

By Steve Axler and Dinorah Gonzalez
(Halliburton)

In today's environment with the restricted ability to obtain credit from financial institutions and the volatility in the foreign exchange markets effective cash management is crucial. One way an in-house corporate tax department can assist their treasury colleagues is to ensure estimated tax payments are properly calculated and paid on time. The failure to do so could mean too much cash is paid which, although results in a favorable balance to the taxpayer when the annual corporate income tax return is filed, represents a cash flow issue. Alternatively, if too little is paid, there will likely be interest and possibly penalties to pay when the return is filed.

In order to maintain adequate internal controls it is not uncommon for the corporate home office located outside of Mexico to approve estimated tax payments. This article provides an overview of how estimated tax payments are calculated in Mexico. The goal of the

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HIGHLIGHTS

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MEXICO

Taxation

Uncertainties of Operating in Mexico - Beyond FIN 48

By Rubén Elías Calles and Mariano Terán
(PricewaterhouseCoopers, S.C.)

(EDITOR's NOTE: This article considers issues which may need to be considered under AICPA's FIN 48 concerning Accounting for Uncertain Tax Positions.)

Mexican tax structure is similar to that of the United States. Among others (VAT, IDE, etc), which are not relevant for purposes of this article, there is an Income Tax (MIT) which, as in the case of the US, taxes what we may call profits from doing business.

Due to the economical ups and downs and to highly effective tax planning, many companies have been reporting tax losses for a considerable time, making it necessary to introduce an alternative minimum tax in order to assure the government receives at least part of what enterprises obtain from doing business in Mexico.

First it was the Asset Tax (AT), that was introduced in 1988 to provide the government with a minimum contribution from Mexican enterprises, whether corporations or individuals.

Even though it is not the intention to explain in detail how this AT worked it is worth mentioning that it carried a tax burden based in the gross financial and fixed assets used in the enterprise operation. The asset base, after some minor adjustments, was first taxed at a 2% rate and eventually came down to 1.25%.

No tax is ever received with joy by the taxpayer, but AT was particularly criticized and detested. Besides being quite complicated to calculate, the legal provisions were somehow obscure and subject to different interpretations, both by the authorities and the tax payer. This resulted in constant legal uncertainty and, since the base was assets, it was argued that this tax obstructed investment in companies.

After 2007, the AT was finally repealed but in its place a new minimum alternative tax came into the Mexican business and tax scene.

IETU

2007 was a year that the next tax that would be the substitute for the AT was being concocted in order to a) provide more resources to the Mexican government and b) reduce as much as possible the possibilities of evading taxes by means of planning vehicles and loop holes in the law.

As it evolved, the objective of developing a different tax scheme started becoming a reality by the introduction of a new "Flat Tax" which was preliminarily called CETU and eventually morphed into the Single or Flat Rate Business Tax (referred to as "IETU" for its acronym in Spanish or "Flat Tax").

A thorough evaluation of the possible risks provided by the Flat Tax should be performed and the valuation of such effects should be kept.

The Flat Tax Law became effective on January 1, 2008 and replaced the Asset Tax law. This Flat Tax is applicable to Mexican resident taxpayers' income from worldwide sources and on income attributed to Mexican permanent establishments (PE) of foreign residents, at a tax rate of 16.5% (17% in 2009 and 17.5% in 2010).

In general, the Flat Tax is based on cash flow represented by the excess of income from the sale or disposition of property, the provision of independent services, and the granting of the temporary use or enjoyment of assets (i.e. rental income and unrelated party royalty income), over amounts paid for: the acquisition of assets, the receipt of independent services and the temporary use or enjoyment of assets, as well as certain other expenses.

Salaries and wages, employer contributions to the social security system, employee non-taxable benefits, most interest income, as well as royalties received from related parties for the temporary use or enjoyment of intangible assets, are not included as income under the Flat Tax law, and payments for these types of expenses are also nondeductible. Nevertheless, the employer is permitted to obtain a Flat Tax credit on "taxable" wages and social security contributions, which provides a similar effect to deducting these items.

As mentioned, this Flat Tax operates as a supplemental tax to the Income Tax, to the extent the computation yields an amount which is higher than the Income Tax for the taxable year. Accordingly, the initial Flat Tax computation is reduced by a "credit" for an amount equal to the Income Tax of the taxable year, as well as the Income Tax arising from distributions of dividends exceeding the cumulative tax basis earnings and profits account (CUFIN).

Beyond FIN 48

AICPA's FIN No. 48 Accounting for Uncertainty in Income Taxes, establishes the accounting for uncertain tax positions, including recognition and measurement of their financial statement effects.

The Description and Scope of Practice Guide for FIN 48 establishes that "generally, companies seek to legitimately reduce their overall tax burden and minimize or delay cash outflows for taxes. Positions taken in tax returns may be well-grounded and taken in good faith, but with the complexities and varying interpretations of the tax law, these may not ultimately prevail. FIN 48 establishes the accounting for uncertain tax positions, including recognition and measurement of their financial statement effects"

As per the above, the question regarding whether uncertainties of the Mexican Flat Tax should be accounted for, arises. And the answer might as well be no, since technically, the uncertainty posed by the loopholes and characteristics of the Flat Tax Law is not a position taken by the entity, but rather is a position created by the Law.

It is well known that Mexico is one of the main three business partners of the US. The proximity, low labor costs, existence of NAFTA and the current tax treaty amongst others, makes it convenient for US companies and investors to either have Mexican subsidiaries or even to formally structure as PE of US entities doing business in Mexico. Of course, the tax established on these subsidiaries and/or PEs in Mexico eventually has an impact not only in the US investor's financial statements but also in its tax structure and consequential compliance in the US. This includes the foreign tax credit (FTC) that in the US may be considered for taxes paid in Mexico.

This Flat Tax poses a series of doubts on the immediate and future impact that it may represent for US investors. The fact of the matter is that, although the uncertainties do not match the FIN 48 criteria to create book adjustments, the following uncertainties are present:

Survival of Either IETU or MIT

In the IETU law itself, it is expressly mentioned that the Mexican Tax Authority will carry out a diagnosis to determine the convenience of repealing the MIT for corporations (general regime), as well as for individuals providing professional services, or engaged in trade or business activities and leasing activities and consequently only keeping the Flat Tax in placed in the longer term. The result of the diagnosis is required to be presented to the House of Representatives no later than June 30, 2011.

IETU Rate

Even though it is established that the applicable rate is 17.5 % a transitional Flat Tax rate of 16.5% and 17% applies for 2008 and the 2009, respectively.

Nevertheless, there is a provision in the Law that considers a revision of rates by the Executive branch in 2009, based on the effects of the tax.

FTC

Without doubt, MIT is in general terms subject to being credited in the US. Nevertheless, even though IETU is designed to be an alternative minimum tax, it is not clear whether it can be credited in the US as a tax similar to an income tax for US purposes or, as it was the case with the repealed AT, no FTC is allowed since it does not match the profile of an Income Tax.

Currently there is a formal pronouncement by the US government that this Mexican IETU or Flat Tax may be considered as creditable, and as a commitment, the IRS will not challenge the FTC until it comes to a conclusion on whether this IETU represents something similar to the US income tax (i.e., if the final conclusion rules that this Flat Tax is not similar to what is considered an income tax for US purposes, then it will cease to be creditable).

As stated, going beyond FIN 48, a thorough evaluation of the possible risks provided by the Flat Tax should be performed and the valuation of such effects should be kept, if not in books, at least in mind when operating in Mexico.

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Mexico, *from page 1*

article is to allow the reader to ask the right questions when reviewing a Mexican corporate estimated income tax payment request.

Overview

Mexican legal entities are required to calculate their monthly income taxes and submit these as estimated payments towards the final annual tax liability. Legal entities are required to use a calendar year for Mexican tax purposes.[1] Taxpayers are not obligated to make estimated payments in their initial year of business but will be required to do so in the second fiscal year.[2] Payments must be submitted no later than the 17th of the following month[3] and will be credited against the tax liability of the annual tax return. Estimated payments are not required when a net operating loss carry forward is greater than the estimated taxable income for the year.[4]

In general terms the estimated income tax payment is calculated taking current year revenue, excluding inflation adjustments and multiplying that by a profit coefficient based on the prior year's results. Specifically, Article 14 of the Mexican Income Tax Law (*Ley del Impuesto sobre la Renta*) identifies the three step procedure in calculating the estimated payment. The first step is to determine nominal income. After arriving at nominal income, the profit coefficient is subsequently determined. Both of these factors are calculated using data from the prior year's income tax return.

Step 1: Determining Nominal Income

Nominal income consists of the cumulative revenue from the prior year excluding the annual inflation adjustment.

Cummulative Revenue	200
Less Annual Inflation Adjustment	75
Nominal Income	125

Step 2: Determining the Profit Coefficient

The profit coefficient is arrived at by dividing prior year taxable income by nominal income.

$$\text{Profit Coefficient} = \frac{\text{Taxable Income/(Loss)} \quad 80}{\text{Nominal Income} \quad 125} = 0.6400$$

In the case that the immediate prior year results do not calculate a profit coefficient, the taxpayer must look-back to prior year returns up to five years.[5]

Step 3: Calculating the Estimated Tax Payment

The profit coefficient will be applied to the current year nominal income, which is current year revenue less inflation adjustments, to arrive at the estimated taxable income. The current tax rate in effect will be applied to the taxable income to derive the estimated payment for the month. It is important to note that cash deposit tax (*Impuesto a los Depósitos en Efectivo*) withheld by financial institutions can be credited against the estimated payment.[6]

CY Nominal Income	350
Profit Coefficient	0.6400
Estimated Taxable Income	224
Tax Rate	28%
Estimated Payment	62.72

If the taxpayer determines the prior year profit coefficient is calculating a higher estimated payment than what is expected for the current year, a request from the authorities for a reduction of payment during the second semester of the year can be made.[7] However, proper authorization is required prior to submitting a lower payment.

Failing to submit the estimated payment in a timely manner, may result in a penalty of $10,720 to $21,430 pesos according to the Article 82 IV of the Mexican Federal Fiscal Code (*Código Fiscal de la Federación*). At the time the annual tax return is filed the total estimated payments paid during the year will be credited against the final income tax due. Interest will be imposed on any outstanding tax liability.[8]

Calculating the IETU Estimated Tax Payment

Monthly estimated payments for the so called alternative "Flat Tax" or IETU *(Impuesto Empresarial a Tasa Unica)* are required in the event it exceeds the estimated income tax payment for that month.[9] Therefore, just as the estimated income tax payment is calculated monthly so too is the taxpayer required to make a parallel calculation of the IETU's monthly estimated payment. However, the IETU is not calculated using a profit coefficient and is based on a cash flow. It will include all collection of revenue arising from the sale of goods (including fixed assets), services, and the granting of the use or enjoyment of goods. This is reduced by allowable expenses which include cash payments for the purchase of inventory, services, and assets. Several credits to consider in the calculation of the IETU estimated payments are the payments for salaries[10] as well as for inventories.[11] The income tax estimated payment will also be a credit in the calculation, and any remaining balance will be classified as the IETU estimated payment. The IETU estimated payment has the same filing schedule as the income tax estimated payment.[12]

Revenue	550
Expense	75
Net IETU Income	475
IETU 2009 Rate	17%
IETU Tax	80.75
Less Salary and Social Contribution Credit	10
Less Investment Credit	5
Less Income Tax Estimated Payment	62.72
IETU Estimated Payment	3.03

1 CFF, Art 11
2 LISR, Art. 14, paragraph 6
3 LISR, Art. 14
4 LISR, Art. 14 II
5 LISR, Art. 14 I
6 LIDE, Art. 7
7 LISR, Art. 15 II
8 CFF, Art. 21
9 LIETU, Art. 10
10 LIETU Art. 8
11 Presidential Decree of November 5, 2007. Art. 1.
12 LIETU Art. 9

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CANADA

Taxation

2009 Federal Budget Presented by Canadian Government

By Chris Van Loan and Andrew Spiro
(Blake, Cassels & Graydon LLP)

With numerous spending initiatives released in the days leading up to the January 27, 2009 Canadian federal budget (the Budget), many wondered whether the presentation of the Budget itself would be anti-climactic. The dollar amount of such measures and the impact of this cost on the government's finances will undoubtedly attract the lion's share of attention in coming days. However, the Budget did contain a few significant and positive tax proposals.

International Measures

a) Repeal of Section 18.2

Perhaps the most significant corporate tax proposal contained in the Budget was the repeal of the so- called "Anti-Tax Haven Initiative" in section 18.2 of the Income Tax Act (Canada) (the Tax Act) before it becomes effective in 2012.

Originally intended to have much broader application, this controversial provision attracted much criticism even after enactment in a much more limited form. As enacted, section 18.2 was applicable to certain types of "double-dip" structures used by Canadian companies to finance their foreign subsidiaries. The provision challenged a longstanding principle that permits the deduction of interest on funds borrowed to invest in shares of a foreign company. The Advisory Panel on Canada's System of International Taxation (the Advisory Panel), in its Report released in December 2008, joined many organizations in urging the repeal of this provision. This recommendation was made, in part, because it was felt that section 18.2 would put Canadian companies at a competitive disadvantage to their foreign competitors.

There is no indication in the Budget documents as to whether the Department of Finance will introduce any proposals in the future aimed at dealing with double-dip financings.

b) Foreign Investment Entity (FIE) and Non-Resident Trust (NRT) Proposals

First introduced a decade ago, the FIE and NRT proposals have had almost as tortured and a much longer history than section 18.2. The ultimate fate of these proposals, however, remains an open question as the Budget documents indicate that they will be reviewed in light of the many submissions received concerning their complexity, uncertainty and breadth. The Advisory Panel, in recommending that the FIE and NRT proposals be reconsidered, noted the issues surrounding the integration of these proposals with the foreign affiliate rules.

c) Outstanding Foreign Affiliate Proposals

The Advisory Panel's recommendations included some far-reaching suggestions relating to the treatment of income from foreign affiliates, as well as capital gains on the disposition of shares of foreign affiliates. The Budget documents announced that the government will consider the Advisory Panel's recommendations before proceeding with the existing backlog of foreign affiliate amendments, originally proposed in 2004 but not yet enacted. While this is a welcome development, it means additional uncertainty in this area.

Without a doubt, the people in the Department of Finance dealing with these proposals, and the NRT and FIE proposals will have a busy year ahead.

d) Other Recommendations of the Advisory Panel

The Budget states that other recommendations of the Advisory Panel are being studied. These recommendations were described in our article "Changing the Borders - Report of Canadian Advisory Panel on International Taxation" (*Practical U.S./International Tax Strategies*, December, 2008, page 8) and included recommendations to amend the thin-capitalization rules that limit deduction by corporations of interest on debt owing to significant shareholders and modifying withholding tax procedures on certain payments made to non-residents in respect of services rendered in Canada on sales of property. Recommendations to amend the thin-capitalization rules would have such rules apply to Canadian branches of foreign corporations and would reduce the debt- to-equity ratio used in the determination of thin-capitalization from 2.0:1 to 1.5:1.

Corporate Measures

a) Acquisition of Control - 'La Survivance' Legislatively Overturned

The Budget proposes an amendment to subsection 256(9) of the Tax Act, which generally deems an acquisition of control of a corporation to occur at the commencement of the day on which such control is actually acquired. It is proposed that this deeming provision not apply for purposes of determining if a corporation is, at any time, a "small business corporation" or a "Canadian-controlled private corporation" (a CCPC).

The purpose of this amendment is to address unintended effects that can result from the strict interpretation of the rule in subsection 256(9) endorsed by the Federal Court of Appeal in La Survivance v. R. The interpretation accepted in that decision meant that where control of a corporation that would otherwise be a small business corporation and a CCPC is deemed to have been acquired by a non-resident at the commencement of the day, but the actual sale giving rise to the acquisition of control does not occur until later in the day, the corporation would not be a small business corporation or a CCPC at the time of the sale. This would affect the vendor's eligibility for the lifetime capital gains exemption under section 110.6 of the Tax Act in respect of the sale or the classification of a capital loss realized on the sale as an allowable business investment loss.

The proposed amendment to subsection 256(9) is intended to prevent this result by ensuring that the deeming rule therein does not affect the status of a corporation as a CCPC or a small business corporation at the time of sale. The proposed amendment will apply retroactively in respect of acquisitions of control that occur after 2005, except for acquisitions that occur before January 28, 2009 in respect of which the taxpayer elects, or is deemed to have elected, on or before the taxpayer's filing due date for the 2009 taxation year that this new measure will not apply. A taxpayer who has relied upon the interpretation endorsed in La Survivance in filing a tax return, a notice of objection or an appeal will be deemed to have made this election.

b) Capital Cost Allowance Measures

The Budget proposes a temporary 100 percent capital cost allowance (CCA) rate applicable to new computer hardware and systems software generally described in Class 50 and acquired after January 27, 2009 and before February 1, 2011. The "half-year rule" which generally limits the amount of CCA that may be claimed in the year of acquisition will not be applicable to such purchases. Certain conditions relating to the use of such property in Canada must be met, and the Budget documents indicate that the computer tax shelter rules will be applicable to computer equipment eligible for this 100 percent CCA rate. The acquisition of qualifying equipment used primarily in manufacturing and processing in Canada is currently eligible for a 50 percent CCA rate on a straight-line basis.

This temporary measure, originally proposed in the 2007 Budget and extended in 2008, was set to expire at the end of 2009 and be replaced by a 50 percent rate applicable on a declining balance basis for 2010 and 2011. (Proposed regulatory amendments to implement the original 2007 proposal were introduced in February 2008, but have not yet been enacted.) The Budget proposes extending the 50 percent CCA rate on a straight line basis for 2010 and 2011. However, the half-year rule will be applicable on such measure.

Finally, the Department of Finance will be consulting with stakeholders with a view to providing accelerated CCA treatment to qualifying property used in carbon capture and storage. The Budget documents do not set out when such an initiative may be expected to be put in place.

c) Small Business Deduction

The Budget increases the base amount of active business income of a CCPC eligible for the small business deduction under subsection 125(1) of the Tax Act (the small business limit) from C$400,000 to C$500,000 as of January 1, 2009. The increase to the small business limit will be pro-rated for corporations with taxation years that do not coincide with the calendar year.

A CCPC's eligibility for the small business deduction will continue to be reduced on a straight-line basis for corporations with taxable capital employed in Canada between C$10 million and C$15 million.

Hopefully the provinces will follow suit and increase provincial small business limits.

d) Mandatory Electronic Filing

Corporate Income Tax Returns—The Budget also includes procedural amendments to the Tax Act which will require corporations that meet certain prescribed conditions to file their tax returns electronically. The proposed amendments in the Budget do not include a detailed description of the conditions that will apply, but indicate that the electronic filing requirements will apply to corporations with annual gross revenues in excess of C$1 million for a taxation year. Exceptions may be made available by the Canada Revenue Agency for certain qualifying corporations such as non-resident corporations, insurance corporations and corporations filing in a functional currency.

The new electronic filing requirements for corporate tax returns will apply for taxation years ending after 2009. The Budget also introduces a penalty, applicable for taxation years ending after 2010, for taxpayers who fail to comply with the new requirement. The amount of the penalty is C$250 for taxation years ending in 2011, C$500 for taxation years ending in 2012, and C$1,000 for taxation years ending after 2012.

Information Returns—In keeping with the objective of improving efficiency through increased electronic filing, the threshold number of information returns required for mandatory electronic filing will be reduced from 500 to 50. A new graduated penalty structure for failure to file information returns on time or in the correct form is also proposed. The maximum penalties under the proposed structure will be determined using fixed brackets based on the number of returns required to be filed. This would be a welcome change from the current regime, which imposes penalties on a per-failure basis and can therefore result in excessive penalties where a large number of information returns is involved. These measures will apply to information returns required to be filed after 2009.

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competitors and a civil offence to deal with other types of agreements between competitors that substantially lessen or prevent competition;

- amend the current merger notification process to mirror the U.S. *Hart-Scott-Rodino Antitrust Improvements Act* process and increase the current merger notification thresholds;
- grant the Competition Tribunal the power to order significant administrative monetary penalties for contravention of the abuse of dominance provisions of the *Competition Act*;
- repeal the provisions relating to price discrimination, promotional allowances and predatory pricing and de-criminalize the price maintenance offence;
- substantially increase the *Investment Canada Act* review threshold for direct acquisitions of Canadian businesses by or from WTO investors (other than acquisitions of cultural businesses); and
- introduce a national security test to the *Investment Canada Act* review process.

A more detailed discussion of the Bill's proposals is set out below.

Proposed Amendments to the Competition Act

Mergers

The Bill proposes that the merger review process in Canada be aligned with the U.S. *Hart-Scott-Rodino Antitrust Improvements Act* procedure. The proposed process involves an initial 30-day waiting period in which a notified merger may not be completed and the government can assess the likely competitive effects of the proposed transaction. Before that 30-day period expires, the government may choose to issue a "second request" for information, in which case the proposed transaction may not be completed until 30 days after the Commissioner of Competition receives the requested information.

The proposal to introduce a "second request" process for Canada is of considerable concern, given the negative experience in the United States and the absence in the Bill of any deadline within which the Competition Bureau must complete its merger reviews.

On the other hand, the Bill does propose two additional changes that are more positive in nature. First, the Bill proposes to increase the thresholds for merger pre-notification. Currently, the *Competition Act* generally requires that the aggregate value of the assets in Canada or the annual gross revenues from sales in or from Canada of the acquired party exceed $50 million in order for the notification requirements to be triggered (the value is currently $70 million for amalgamations). The Bill would increase this threshold for all forms of transactions to $70 million initially, with future increases tied to changes in inflation (or as prescribed by regulation).

Second, the Competition Bureau's ability to review mergers after closing would be reduced from the current three years to one year post-closing, providing greater certainty to parties post-merger.

Conspiracy

The Bill proposes to repeal the existing conspiracy provisions and replace them with a *per se* criminal offence for "cartel-like" agreements between competitors to fix prices, affect production or supply levels of a product, or allocate sales, customers or territories. The proposed provision does not require evidence that the conspiracy would be likely to lessen competition or allow for an efficiencies defense. However, liability will be avoided if the agreement is "ancillary" to a broader agreement that does not contravene the conspiracy offense and is necessary for giving effect to the objective of that broader agreement. Maximum penalties under this provision are proposed to be raised to 14 years imprisonment and a $25 million fine, from the current five years and $10 million.

The proposed civil provision would apply to any other agreement between competitors that has the effect of lessening or preventing competition substantially. Under the proposed legislation, the Commissioner of Competition could apply to the Competition Tribunal for a remedial order to deal with such agreements.

Similar proposals to amend the *Competition Act*'s cartel provisions were suggested in the past. However, they generated significant opposition and were not enacted because of doubts about the need for a *per se* offence and concerns about how to distinguish in practice between illegal "hard core" cartel conduct and legitimate "ancillary" conduct.

Other

Other proposed amendments to the *Competition Act* include:

- granting the Competition Tribunal the power to order an administrative monetary penalty of up to $10 million for a contravention of the abuse of dominance provisions and up to $15 million for subsequent offences;
- expanding the bid-rigging offence to include situations where one person agrees with another to withdraw an already-submitted bid;
- repealing the price maintenance offence and replacing it with a new civil provision, which would also be subject to private enforcement before the Competition Tribunal; and
- expanding the misleading advertising offence to apply to Canadian companies targeting foreign individuals.

Proposed Amendments to the Investment Canada Act

The Bill also contains a number of proposed amendments to the *Investment Canada Act*, the two most significant of which are an increase of the thresholds applicable to most direct acquisitions of Canadian businesses and the addition of a national security review process:

- Direct acquisitions of Canadian businesses (other than acquisitions of cultural businesses) by or from WTO investors would be reviewable under the *Investment Canada Act* only if the "enterprise value" of the assets of the Canadian business is equal to or greater than (a) $600 million, in the case of investments made during the first two years after the amendments come into force; (b) $800 million, in the case of investments made during the third and fourth years after the amendments come into force; and (c) $1 billion, in the case of investments made between the fifth year after the amendments come into force and December 31 of the sixth year after the amendments come into force. This threshold would thereafter be adjusted on an annual basis. In addition, the lower thresholds ($5 million) currently applicable to the transportation, financial services and uranium sectors would be repealed. "Indirect" acquisitions of Canadian business by WTO investors would continue to be subject to post-closing notification only, rather than review.
- A new review process for investments that could be "injurious" to national security would be introduced. The proposed amendments would, among other things, allow the federal Cabinet to take any measures that it considers advisable to protect national security, including the outright prohibition of a foreign investment in Canada. Time frames for the national security review process have not yet been determined.

Other proposed amendments to the *Investment Canada Act* include:

- requiring the Minister to provide reasons for a decision to deny approval to a transaction;
- allowing the Minister to communicate or disclose privileged information obtained as a result of the review of an investment to prescribed investigative bodies, provided that such communication or disclosure is for the purpose of the administration and enforcement of the new national security provisions and those bodies' lawful investigations;
- permitting the Minister to disclose that an application for review has been filed under the *Investment Canada Act* (other than an application under the national security review provisions) and to report on the progress of that application, provided that disclosure does not prejudice the investor or the target; and
- allowing the Minister to "accept" new undertakings from an investor if the investor has failed to comply with existing undertakings.

Implications

The Bill's proposed amendments to the *Competition Act* represent the most significant changes to that statute since it was enacted in 1986. The *Competition Act*'s core provisions - cartels and merger review - will be substantially altered. The proposed changes to the *Investment Canada Act*, particularly with respect to thresholds and national security, would be significant as well.

Concerns about the scope of certain of the proposed changes (particularly the cartel and merger amendments to the *Competition Act*) are only magnified by concerns with the legislative process adopted by the Canadian government to secure their enactment. Typically, for example, amendments to the *Competition Act* have been preceded by consultations with stakeholders to ensure that their views are taken into account and that potential issues are properly considered. In this case, however, the proposed amendments in the Bill are part of a larger budget implementation process that is expected to see the Bill enacted quickly because it contains measures designed to "stimulate" Canada's economy. As a result, there is unlikely to be much in the way of prior consultation or room to suggest modifications to the proposed *Competition Act* and *Investment Canada Act* amendments.

A lack of consultation would be unfortunate. There has been no explanation as to why the proposed changes to the *Competition Act* or *Investment Canada Act* must be enacted with such haste. It is hard to believe that these amendments are a critical component of the government's strategy to jump start the Canadian economy. Indeed, there is much concern that certain of the proposed changes (e.g., the "second request" process) will have the precise opposite effect, by creating additional uncertainty and raising costs for businesses at a time of economic turmoil.

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UNITED STATES

Taxation

U.S. Makes Similar Agreements with France and Germany Detailing Mandatory Binding Arbitration Procedures for Unresolved Competent Authority Disputes

By Tamara W. Ashford (Dewey & LeBoeuf LLP)

On January 13, the United States and France signed a new protocol making several significant changes to the U.S. French income tax treaty. Chief among the changes is that the new protocol provides for mandatory, binding baseball-style arbitration of certain unresolved competent authority disputes.

Such a provision may signal the latest trend in bilateral income tax treaties. Once ratified, the U.S.-French income tax treaty will be the fourth U.S. bilateral income tax treaty in the past two years providing for a mandatory, binding baseball-style arbitration process to supplement the negotiation process used in the mutual agreement procedure ("MAP"). On December 28, 2007, protocols amending the U.S. income tax treaties with Belgium and Germany entered into force, and a protocol amending the U.S.-Canadian income tax treaty entered into force on December 15, 2008. Each protocol provides for mandatory, binding arbitration of unresolved competent authority disputes, and the arbitration is baseball-style arbitration, in which each side will submit a settlement proposal to a three-person panel of arbitrators and the panel will choose one or the other settlement proposal.

MOUs

In addition to the U.S.-French protocol, the U.S. and France signed a memorandum of understanding ("MOU") agreeing on mandatory arbitration procedures. This MOU comes on the heels of the U.S. and German competent authorities just last month entering into a MOU and agreeing to a set of arbitration board operating guidelines for how the new mandatory arbitration provision in the U.S.-German income tax treaty will work.[1]

While U.S.-French arbitration procedures are quite similar to the U.S.-German procedures, the U.S.-German MOU signed on December 8, 2008, coupled with the arbitration board operating guidelines, provides significantly more detail and plainly sets the stage for the IRS to begin taking unresolved MAP cases with Germany to arbitration now. With respect to both French and German unresolved MAP cases, arbitration proceedings shall begin on the later of (1) two years after the commencement date of the case, unless both competent authorities have agreed prior to the date arbitration proceedings begin to a different date, and (2) the earliest date upon which the nondisclosure agreements were received by both competent authorities. Specifically included in the U.S.-German MOU as eligible for arbitration is an unresolved competent authority request that originated with a bilateral advance pricing agreement ("APA") request, but only to the extent tax returns were filed with respect to all taxable years at issue. The U.S.-French arbitration process is silent on whether APA cases are eligible.

Arbitration Boards

Each MOU also outlines how arbitration board members are to be appointed, but there are slight differences in their respective appointment processes. For U.S.-German arbitration cases, each competent authority appoints a member to the arbitration board, with those two members appointing a third member, who will serve as chair. If either competent authority fails to appoint a member, or if the two appointed members fail to agree upon the third member, the highest- ranking member of the Secretariat at the OECD who is a citizen of neither the United States nor Germany will be contacted to make the necessary appointments. For U.S.-French arbitration cases, if the two members appointed by the respective competent authorities fail to agree upon the third member, those members will be dismissed, and each competent authority must appoint a new member of the panel within 30 days of the dismissal.

Under the U.S.-German MOU, the competent authorities are to appoint board members who have "significant international tax experience," but they need not have experience as either a judge or an arbitrator;[2] board members cannot be current government employees or former government employees within two years of their last employment in the government; and the competent authorities will identify and jointly agree to five to ten persons who are qualified and willing to serve as a chair for an arbitration board, with the list being reviewed or revised by the competent authorities every three years. The U.S.-French MOU, on the other hand, simply provides that the members appointed shall not be employees of either country's tax administration; the competent authorities "shall develop a non-exclusive list of individuals with familiarity in international tax matters who may potentially serve as the chair of the panel"; and the chair shall not be a citizen of either country.

The U.S.-German MOU outlines the information to include in proposed resolution and supporting position papers. Each competent authority in a U.S.-German arbitration proceeding is permitted to submit a proposed resolution paper and a position paper that takes alternative positions. For example, in a U.S.-German case involving a permanent establishment issue, a competent authority may take the position that no permanent establishment exists or may propose an amount of income to be allocated to a permanent establishment if the board determines that a permanent establishment exists. In a U.S.-French arbitration proceeding, the taxpayer is also permitted to submit a position paper to be considered by the arbitration panel, but the U.S.-French arbitration process makes no mention of whether alternative positions can be presented in a proposed resolution paper or a position paper. However, in both U.S.-French and U.S.-German arbitration proceedings, if only one side submits a proposed resolution, then that resolution shall be deemed to be the determination of the arbitration board and the case will be terminated. Unlike the U.S.-French MOU, the U.S.-German MOU and operating guidelines call for the separate consideration and determination of multiple issues in a case. Thus, arbitration of transfer pricing disputes, which comprise a significant portion of the Internal Revenue Service's ("IRS's") inventory of MAP cases, could, for example, involve separate consideration and determination by the arbitration board of a royalty transaction with one transfer pricing methodology and a services transaction with another transfer pricing methodology. It is unclear under the U.S.-French MOU whether an arbitration panel can similarly consider and make a determination on each issue individually.

An arbitration panel's determination must be delivered in writing without rationale or analysis within six months of the appointment of the chair in a U.S.-French arbitration proceeding. The arbitration board in a U.S.-German proceeding has nine months.

MOUs and guidelines detailing the arbitration procedures under the U.S.-Canadian and U.S.-Belgium income tax treaties apparently are in the works. It will be interesting to see how similar those procedures and guidelines will be to the U.S.-German procedures and guidelines in particular. It will also be interesting to see whether additional procedures and guidelines will be issued by the United States and France to more effectively implement the mandatory arbitration process under the U.S.-French income tax treaty.

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[1] *See* Ann. 2008-124, IRB 2008-52 (Dec. 29, 2008); Ann. 2008-125, IRB 2008-52 (Dec. 29, 2008); *see also* http://www.irs.gov/businesses/international/.

[2] According to IRS officials speaking at the October 2008 TEI New York Chapter LMSB Financial Services Industry Conference, the IRS released two requests for information—one for companies that might be interested in handling the arrangements for obtaining arbitrators, and one for those who might be interested in arbitrating.

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IRS Issues Revised Cost Sharing Regulations

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Taxpayers that have relied on cost sharing arrangements under the 1996 regulations must consider whether and how such reliance will be viable in the future under the new regulations.

Overview

On December 31, 2008, the U.S. Treasury Department and the Internal Revenue Service (IRS) issued temporary regulations making fundamental changes to the 1996 rules governing qualified cost sharing arrangements (CSAs). These changes are relevant not only to taxpayers that rely on CSAs, but also to taxpayers that have never implemented a CSA, as Treasury and the IRS have provided for application of the principles of the new regulations to intangible development arrangements in general.

The new regulations are based on regulations proposed in 2005, which have been the subject of considerable discussion and controversy. The new regulations are generally effective as of January 5, 2009, subject to limited transition relief for certain pre-existing CSAs. The new regulations also were issued in proposed form and will be the subject of a public hearing scheduled for April 21, 2009.

Buy-Ins

The new regulations expand the range of circumstances under which buy-in payments are required in order to compensate CSA participants for contributing intangible property or other resources to the CSA, with minor changes from the approach set forth in the 2005 proposed regulations. The 2005 proposed regulations required buy-in payments for all "external contributions," defined to include any resource or capability, whether or not constituting intangible property, reasonably anticipated to contribute to the development of the cost-shared intangibles. The 2005 proposed regulations determined the arm's length charge for such contributions by means of a hypothesized "reference transaction," in which all such resources and capabilities are provided on an exclusive and perpetual basis (effectively providing a conclusive presumption in this regard).

The new regulations modify some of the relevant nomenclature (e.g., "external contribution" has become "platform contribution") but continue the basic 2005 approach that buy-ins may be required with respect to all "contributions," including with respect to items generally not thought to constitute intangible property, such as research workforce in place, goodwill and going concern value. The new regulations eliminate the "reference transaction" construct, replacing it with a rebuttable presumption that all relevant resources, capabilities and rights are made available on an exclusive basis.

Investor Model

The new regulations adhere to the "investor model" set forth in the 2005 proposed regulations, under which each CSA participant is generally expected to earn a return on its aggregate investment of cash, intangible property and other resources in the CSA in line with a risk-adjusted discount rate for the entire CSA. This approach will significantly limit the returns that can be realized by a CSA participant that contributes cash and bears development risk but does not contribute pre-existing intangible property or other resources or capabilities. Such a participant effectively will earn only a discount rate on its cost contributions, with the bulk of non-routine profits being allocated to participants that contributed pre-existing intangible property or other resources or capabilities. The determination of an appropriate risk-adjusted discount rate will be particularly important under this approach, and can be expected to be the subject of considerable contention between taxpayers and the IRS. The new regulations provide expanded guidance concerning the determination and application of discount rates for this and other purposes.

Taxpayers that have relied on CSAs under the 1996 regulations must consider whether and how such reliance will be viable in the future under the new regulations.

Design Flexibility

In some respects, the new regulations allow greater flexibility in the design of a CSA than the 2005 proposed regulations would have allowed, but far less than has existed since 1996. The 2005 proposed regulations would have required CSA participants to divide the rights to exploit cost-shared intangibles into exclusive and perpetual rights for non-overlapping geographic territories. The new regulations continue to require non-overlapping exclusive and perpetual rights, but allow these rights to be divided on a territorial basis, a field-of-use basis or an appropriate unspecified basis, subject to certain restrictive conditions.

In an important concession to taxpayer criticism, the new regulations also provide more flexibility than the 2005 proposed regulations did with respect to the form of buy-in payments. The 2005 proposed regulations would have required buy-in payments for contributions of resources or capabilities acquired post-formation to take the same form as the payment for the underlying acquisition itself. The new regulations abandon this rule and allow the participants to choose the form of payment for any contribution, including post-formation acquisition contributions.

Periodic Adjustments

The new regulations narrow the return ratio range that is used for determining when the IRS generally will consider proposing periodic adjustments to buy-ins under "commensurate with income" (CWI) principles.

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The 2005 proposed regulations provided that periodic adjustments normally would be considered where a participant's actual operating profits divided by the discounted present value of its investment in the CSA fell outside the range of 0.5 to 2.0. The new regulations narrow that range to 0.667 to 1.5, based on a view that a return ratio outside that range suggests the potential of non-arm's length pricing at the time of the contribution of intangible property or other resources to the CSA. As with the 2005 proposed regulations, a narrower range applies in cases in which the taxpayer fails to substantially comply with documentation requirements (0.8 to 1.25 under the temporary regulations). Periodic adjustments likely will be considered with increased frequency under the new rules.

The preamble to the new regulations states that the IRS intends to issue a revenue procedure excluding from the periodic adjustment rules platform contribution transactions (i.e., contributions necessitating a buy-in) that are covered by an advance pricing agreement (APA). Such an exception would be premised on the view that the APA process may serve to overcome information asymmetries between the taxpayer and the government, thus eliminating a primary basis for application of the CWI rules. The IRS has defended the CWI rules as being consistent with the arm's length standard on the basis that the rules allow the IRS, as the party with less information about the relevant transactions and assets, to use ex post results merely as a guide to determining what the reasonable ex ante expectations of the parties would have been (as opposed to using hindsight to deny the payor an appropriate return on bearing risk).

The preamble to the new regulations also states that Treasury and the IRS considered providing a similar exception to the periodic adjustment rules for cases in which taxpayers complied with heightened contemporaneous documentation requirements, and that comments are invited on whether or how such a documentation-based exception could be developed.

Pricing Methods and Discount Rates

Like the 2005 proposed regulations, the new regulations provide guidance on specific pricing methods (including the controversial income, acquisition price and market capitalization methods, as well as limits on the application of the residual profit split method). The new regulations also provide guidance on the determination of appropriate risk-adjusted discount rates used for such purposes as applying the investor model and computing present values under the periodic adjustment rules described above. In both of these areas, the new regulations are broadly consistent with the 2005 proposed regulations, but modify the approach in several respects. Of particular note, the new regulations eliminate the focus in the 2005 proposed regulations on a taxpayer's weighted average cost of capital or hurdle rate in determining the appropriate discount rate for participation in a CSA, and also address differences between pre- and post-tax discount rates.

Impact on Non-CSA Arrangements

In addition to the possibility that the cost sharing regulations may be applied to certain intangible development arrangements meeting some, but not all, of the requirements under the regulations, the new regulations also provide for a much broader application of the principles of the regulations to nonconforming intangible development arrangements in general. Specifically, the new regulations modify the current general rules dealing with transfers of intangibles and controlled services transactions (Treas. Reg. § 1.482-4 and -9) to provide specifically for "consideration of the principles, methods, comparability, and reliability considerations" set forth in the new CSA regulations in determining the best method for pricing intangible development arrangements subject to these other rules. Thus, even if the IRS decides not to treat a nonconforming co-development arrangement as a CSA, it may nonetheless apply certain of the general rules and principles applicable to CSAs in determining the arm's length result of the nonconforming arrangement.

The ramifications of this general application of the new regulations' principles are unclear, but this general application is consistent with the IRS's apparent (and controversial) view that the new regulations are consistent with general transfer pricing principles. Indeed, a number of IRS releases in recent years have included elements of the new regulations in interpreting and applying general principles (e.g., 2007 and 2008 Large and Mid-Size Business directives on section 936 conversions, 2007 advice memorandum on the CWI rules, 2007 coordinated issue paper on CSAs). In addition, the Organization for Economic Co-operation and Development's September 2008 discussion draft on "business restructurings" includes some of the same themes, such as an emphasis on realistically available alternatives; broader scope of circumstances requiring "buy in" or "buy out" payments; and general orientation toward reducing the return allocable to entities that bear risk without having "control," performing other key activities or contributing resources other than cash. By explicitly providing for general application of the principles of the new regulations, Treasury and the IRS appear to have confirmed their view that the regulations are consistent with other developments in the transfer pricing area. This general application of the principles of the new regulations also may represent another effort on the part of the IRS to further one of its main stated goals in its recent guidance activities in the area, to provide for similar tax treatment of economically similar arrangements, regardless of structure.

Effective Date

The new regulations generally apply as of January 5, 2009, (the date on which the regulations were published in the Federal Register) and, as temporary regulations, will expire in three years. Pre-existing CSAs may obtain grandfather relief, provided that certain contract and administrative requirements are satisfied (including the requirement that existing contracts be amended within six months to conform to the new regulations' contract provisions). The all-purpose grandfathering termination provisions of the 2005 proposed regulations have been rejected in favor of narrower provisions that may produce additional payment obligations in certain circumstances involving a material change in the scope of the CSA. However, given that the IRS appears to have concluded that much of the content of the new regulations is implicit in the current 1996 regulations, and that benefits of grandfathering are subject to termination in the event of a material change in scope, it remains to be seen how valuable this grandfathering will prove to be as a practical matter.

Conclusion

Although the new regulations include some helpful clarifications, simplifications and additional flexibility relative to the 2005 proposed regulations, the basic approach is the same and has now been given effect in the form of temporary regulations. As a result, CSAs will be considerably less beneficial and practical than they have been in the past for companies with research resources and capabilities centered in the United States. On the other hand, these same provisions will make CSAs considerably more attractive for taxpayers with substantial foreign research resources or capabilities.

Taxpayers that have relied on CSAs under the 1996 regulations must consider whether and how such reliance will be viable in the future under the new regulations. Even taxpayers that have never entered into a CSA should consider the implications of the application of the principles of the new regulations to other intangible development arrangements.

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