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North American
Free Trade & Investment Report

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

Canada: Foreign Investment

Foreign Investment Review in Canada—More Changes on the Horizon?

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

Apart from the *Investment Canada Act*, which generally governs foreign investment in Canada, specific and more restrictive rules also apply to particular industries that are deemed to require greater protection. These restrictions are contained in various statutes and government policies.

In June 2008, the federally-appointed Competition Policy Review Panel recommended that both general and sector-specific restrictions

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NAFTA Export Planning

Five Steps for Navigating NAFTA's Technical Barriers to Trade

By Bryan A. Elwood
(Curtis, Mallet-Prevost, Colt & Mosle, LLP)

A key to proper export planning is ensuring that one's product or service can safely navigate past a growing number of technical barriers to trade (TBTs). TBTs are laws or regulations requiring that a product or service conform to a specified standard of quality, performance, safety or dimension as a condition for importation. Exporting anything without knowing whether any TBT standards-related measures (SRMs) apply, and exactly how they apply to the exported product or service, can result in hefty penalties, recalls and even costly returns of the infringing products.

Furthermore, as countries become increasingly concerned over their environment, food safety, health and pollution, technical regulations

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HIGHLIGHTS

Vol. 20, No. 6
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Two recent developments indicate that changes to sector-specific rules governing foreign investment in Canada may now be on the horizon.
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A look at how the new U.S. Foreign Account Tax Compliance Act provisions affect Mexican residential trusts.
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The upcoming G20 meeting in Canada in June 2010 presents a perfect opportunity for Canada to join ICSID. It is one of a few countries which has not ratified the agreement. The provision has important provisions for international investors such as arbitration benefits.
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MEXICO

Taxation

Navigating Mexico's Thin Cap and Related Foreign Party Finance Rules

An Exclusive Interview with Fred J. Barrett, PricewaterhouseCoopers Mexico

Conducted by Gary Brown and Scott Studebaker

Q: How do Mexico's thin capitalization rules work now?

BARRETT: The Mexican thin capitalization rules are fairly simple in the sense that they are a mechanical calculation. Essentially, if your company exceeds the 3:1 debt-equity ratio, which includes all debts – not just related parties but also unrelated, as well as foreign and domestic – you're potentially in a thin capitalization situation. What does this mean? It means that if you have too much debt, and if some of that debt is from related parties, the tax law considers the excess debt from related parties not a loan but capital. Why? The theory behind the mechanical calculation is that no independent party would lend an excessively risky sum of money. And so, if you exceed 3:1 considering all of your debts, then Mexico will disallow the related party foreign debt exceeding the ratio to bring you effectively back down to the 3:1 debt-equity ratio for tax purposes. If the associated interest expense is thus disallowed, it is treated as a non-deductible dividend. So essentially it is a mechanical calculation that does not require a whole lot of thought.

Q: What happens if the debt you have is revalued for currency purposes? Is there any kind of currency calculation in all of this?

BARRETT: Let's say you have a dollar loan and, at the end of the year, there is a devaluation. That dollar loan would then turn into a increased debt on a peso balance sheet, and therefore there would be more disallowance because you increased your excess over 3:1. However, conversely, if instead of a devaluation there was a positive valuation adjustment to the peso compared to the dollar, then you would actually reduce your limitation. So, currency changes can either help or hurt you. And in fact, this past year, the peso actually strengthened compared to the dollar. Even though we started out with a big devaluation that occurred in January and February of 2009, the peso is much stronger today.

Q: So for thin cap considerations, companies essentially need to focus on foreign related loans and not domestic loans nor loans with domestic related parties. Is that correct?

BARRETT: That is correct. So, related party domestic loans would not be disallowed.

The back-to-back loan provision was a theoretical risk until 2009, at which time the tax authorities first challenged a deduction in a transaction, under this provision.

Q: Are there any ambiguities in the rules that should be highlighted?

BARRETT: No, there are no ambiguities. The thin cap rules were enacted in 2005, and there was a five-year transition rule, which provided that if you exceeded the 3:1 ratio at the end of 2004, the authorities would give you five years to bring down that difference. It is unclear in the way the law was written whether a company has to actually reduce the difference proportionally over five years or if the company just has to comply by the end of the five-year period. So, some companies took the position that you just had to comply by the end of 2009, and Hacienda has not challenged this argument as of the present time. However, if a company did not reduce the difference by the end of 2009, then the Hacienda might take the position that the company's tax returns were wrong for all of the years: 2005, 2006, 2007, 2008 and 2009. So, that was really the only ambiguity: whether a company had to reduce the difference proportionally every year or whether it just needed to be reduced by the end of the fifth year.

Q: How do the tax authorities measure the 3:1 ratio?

BARRETT: The measurement is based on Mexican GAAP: Mexican Generally Accepted Accounting Principles. In the financial statements, you simply look at the ratio of the liabilities on the balance sheet compared to the equity, and if the ratio's more than 3:1, you take an average of the beginning and end of the year for equity, and an average annual amount for debts based on month end balances determination for debt during the calendar year. So mechanically, it is simply looking at the "book equity", or the financial statement equity at the beginning and end of year, compared to the annual average monthly financial statement debt, which is based on the terms of the loans in the applicable contractual agreement. For instance, if it is debt on the basis of a dollar currency, you have to adjust that dollar currency to the peso balance at the end of the applicable month.

Advance Pricing Agreements

Q: Is there much use or experience with advance pricing agreements to address situations where the ratio is higher than 3:1?

BARRETT: There is a specific provision that allows you to exceed 3:1 if you get an advance pricing agreement (APA). There have not been many; just from knowing and talking to the tax authorities on a regular basis, I would not be surprised if there have been less than half a dozen cases in the entire country. It is probably a low priority for the authorities, because it would mean that they would collect lower income taxes. So it has been done, but it is not very usual. A company would have to have a really good story as to why it should exceed 3:1. It would have to show the authorities really strong comparables in the same industry, demonstrate how companies are always leveraged at a higher than 3:1 ratio in that specific industry with unrelated parties, and just generally make a good case supported by transfer pricing studies. I am personally aware of about three APAs; one of them took four months, another of them took about a year, and another has not even been finished yet and has been going on for several years. So, basically, the tax authorities are not going to be very compelled to help you exceed the 3:1 ratio. On the other hand, you have nothing to lose by going the APA route if you already know you are going to exceed the 3:1 debt to equity ratio.

Q: I'm told that the 3:1 could be exceeded for certain activities. What are some examples of exceptions?

BARRETT: There are exceptions to the extent that certain infrastructure projects in strategic areas are financed abroad for dams, ports, airports and highways. Those industries include:

- Oil and gas
- Basic petrochemistry
- Electricity
- Nuclear energy generation
- Radioactive minerals
- Telegraphy
- Radiotelegraphy
- Mail
- Money printing
- Control, supervision and surveillance of ports, airports and heliports

In those situations, you are exempted from those rules, and for those specific activities, you may be able to exceed the 3:1 ratio.

Q: What are some of the strategies for coping with thin capitalization rules?

BARRETT: The easier strategy is to capitalize the debt if you exceed 3:1, because if you do exceed that ratio, it is treated as a non-deductible dividend. This could hurt you, because it would reduce your after tax earnings account, known as CUFIN in Mexico, and you would want a high CUFIN so that you could distribute your earnings tax-free to the shareholders.

A second alternative is to try to refinance your debt, by using either more domestic (with parental guarantees) or more unrelated party financing. This can be done easily enough, especially if you have some sort of implicit guarantee from your corporate parent abroad and certain other requirements are satisfied. There is also a calculation option permitting you to elect to use tax basis equity instead of GAAP equity. In this case, the tax basis equity would consist of the sum of average (of beginning and end of the year) CUFIN and CUCA (meaning basis in shares without counting CUFIN) but you have to stick with that option for a five-year period. That option can prove beneficial from a calculation standpoint, if it gives you a higher ratio threshold comparable.

Q: Is there any way to use hybrid loans as a work around?

BARRETT: No, you cannot generally have a hybrid loan from a Mexican standpoint, but you can from a foreign one. It will usually be treated as a loan in Mexico for legal purposes, even if it is a hybrid for another country. A loan is a loan in Mexico, and therefore you are still going to have the 3:1 issue on those hybrids. Sometimes hybrids do provide benefits from a global standpoint; even though it

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is interest in Mexico, it is not income in another country, and you should get a deduction in Mexico. A hybrid loan might not be taxed in another country, but that would not help you avoid the 3:1. The foreign hybrid is just an overall tax planning strategy so that on a global basis you might get a lower effective tax rate.

Q: Mexico's thin cap rule seems fairly generous in the sense that many countries are below that ratio, even in Latin America. Additionally, the rules look to group related and unrelated companies as well as cover guarantors when a company has parallel loans. Is there any movement within Hacienda to tighten up the thin cap rules?

BARRETT: You are right. The rules are generous. We performed an analysis of public Mexican companies and most do not exceed 3:1 debt equity ratio. Notwithstanding, there is no current push by the authorities to tighten the rules. I think that if Hacienda believes you are abusing the rules, they can get you under regular transfer pricing concepts. If the loan does not smell like a loan, if it has more characteristics of capital, Hacienda can disallow the interest. They can argue that, on an arm's length basis, an independent party would not lend that amount. Balloon loans are occasionally used from a related party standpoint, where you do not pay anything back until the end of 15 or more years. If you cannot find independent parties that have those terms, you are going to have a much more difficult time convincing the tax authorities that it is debt and not really an element of capital. Moreover, several specific provisions in the law can be used to disallow interest deductions, including interest exceeding fair market value, interest expense exceeding interest income and the "strictly indispensible" provision in relation to the business expense. So, from a transfer pricing and legal perspective, the tax authorities have all the flexibility in the world to attack abusive situations. They probably do not consider that they need to enact major changes there. From a fairness standpoint, it appears that they should allow you to carry interest forward like the US does, at least for whatever is disallowed under the mechanical 3:1 calculation. In the US there is a 1.5 to 1 ratio, but any excess kicked out under the mechanical computations can be used in future years. However, in Mexico, when the excess is kicked out, it automatically becomes a dividend. So, that is kind of harsh in my view and it is where tax advisors can help by planning around it.

Q: Short of a formal advance pricing agreement, is there any way to get guidance in this area from the tax authorities?

BARRETT: If you exceed the 3:1 ratio, there really is no guidance. It is non-deductible unless you get an APA. However, before you submit an APA, you might want to get a feel for whether the authorities would actually give you an APA allowing a greater than 3:1 ratio. On a no-name basis, I might recommend going to the tax authorities and saying, "Look. This is my industry. This is my study. These are my comparable transactions for my independent parties. What do think my chances are of you giving me an APA?" You can get a feeling from them on that issue. Otherwise, the rules are generally black and white; if the law says you exceed 3:1 and it is non-deductible, then it is non-deductible. There is neither flexibility nor special concessions, other than through this APA process.

Q: And are there any restrictions relating to loans from companies in low tax jurisdictions?

BARRETT: Mexico has a harsh rule, which says that withholding tax is extremely high for loans from low tax jurisdictions. There is a 40% withholding rate. Therefore, it makes such loans cost-inefficient. You would not even get to the thin cap rules.

Q: What are some other problem areas for the ability to deduct interest, such as the use of back-to-back loans?

BARRETT: Foreign banks that are registered in Mexico have a 4.9% withholding rate. However, if a taxpayer uses its related party to obtain a loan, it could involve a withholding as high as 25%, or sometimes 10% or 15% under an applicable treaty. For example, what you might do is get an intermediary – a bank – to lend the money to your subsidiary; but you would also deposit an equal amount of funds within that bank, so that effectively you were really financing the subsidiary while still being able to get a lower withholding tax through this banking intermediary. As a result, the Mexican tax authorities enacted the rule that if one party lends money to another party, who in turn uses those funds to lend money to the first party or its related party, then it is considered a back-to-back loan. Thus, even many valid loan transactions could potentially fall victim to this rule, and it would cause the interest to be non-deductible. The back-to-back loan provision was a theoretical risk until 2009, at which time the tax authorities, to my knowledge, first challenged a deduction in a transaction, under this provision. It has not been in court yet, but nonetheless it has become something more than a theoretical rule as a result of this audit.

Q: So, the back-to-back loan rules sounds like a game changer within your jurisdiction.

BARRETT: Yes. Everybody is now more nervous that the authorities might allege the back-to-back loan rules, as they are worded so broadly. It is imperative to evaluate your loan terms and see if there is a way around them, because this rule is very harsh and would basically treat interest paid abroad as non-deductible. It does not matter if it is a related or unrelated party. As mentioned, the rules basically state: "A back-to-back loan is considered to exist when a person provides assets or services to another person, and that other person in turn provides directly or indirectly assets or services to the first person or related party of the first person." It is not clear whether there is a direct tracing of the money that is transferred and the money that is sent back. It is worded so broadly that it could be interpreted as trapping many taxpayers in that situation.

The Mexican thin capitalization rules are fairly simple in the sense that they are a mechanical calculation. Essentially, if your company exceeds the 3:1 debt-equity ratio, which includes all debts – not just related parties but also unrelated, as well as foreign and domestic – you're potentially in a thin capitalization situation.

The tax authorities would probably only use this rule when they are desperate, such as when they see that somebody has done a debt restructuring transaction, such as some sort of debt push down, and they do not have another way to attack it. For example, if a transaction is properly structured under the law, has economic substance, and there is a business purpose to it, but the tax authorities may perceive you are trying to get a tax benefit and simply do not like the fact that there is interest that is draining the revenues of the country from a tax perspective, then they might attack this via the back-to-back loan rule. So, the word of caution would be to not engage in abusive debt restructurings and properly document and support your transactions with competent transfer pricing analyses showing how cash earnings of the company will fund the debt. By its very nature, 3:1 debt to equity planning is not abusive, so it would have to be some other transaction where you had a purely tax motivated transaction and had developed some loophole around the 3:1, and you avoided the withholding tax by using a bank intermediary. Essentially, if the tax authorities perceive that you are solely trying to obtain a tax benefit, they might assert back-to-back loan disallowance and, therefore, disallow the interest deduction.

Economic Substance

Q: Do you have any other observations about debt restructuring for Mexican subsidiaries?

BARRETT: Notwithstanding the 3:1 requirement, it is still very viable to do debt structuring transactions with debt being pushed down into the subsidiaries. It is often necessary from a business standpoint, as well as very beneficial from a global standpoint, to do it as long as you have economic substance. These loans are going to be scrutinized, but you should be sustained in an audit in keeping the deduction as it makes its way to the tax tribunals. At the end of the day, you should be sustained as long as there is economic substance to the structuring. Another important factor to consider is that any debt needs the support to show that the cash flows would cover the funding of the principle and interest. If your cash flow projections do not demonstrate the ability to repay the debt, you are going to have a hard time sustaining deductibility of your interest in Mexico.

Q: Can you give an example of the problem?

BARRETT: Let's say I do a debt restructuring showing a very large debt. Even if I meet the 3:1 ratio, the debt will be disallowed under transfer pricing concepts if the cash flows that I expect to generate from my business would not be able to fund the principle when payment falls due and interest over the term of the related party loan. The tax authorities would say that that this is not interest, because an unrelated party would not loan money that cannot be repayable from the cash flows of the company. They would argue that an independent party would not have loaned that money because the borrower is not sufficiently liquid. So, if your cash flows don't show that you are going to have enough cash flow earnings to service the debt, the tax authorities are simply going to disallow the interest to foreign related parties. And their disallowance would be completely justifiable in those circumstances.

Sometimes there are restructurings that do not demonstrate that the debt is clearly fundable from the cash flow of the business. How do you determine this? You look at the borrower's history. If a company has a history of doing business in Mexico and if that history doesn't show a prevailing tendency of cash flows and you can't justify a change in that cash flow, the tax authorities are

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going to say you never intended to repay that loan in the first place and that, therefore, it is not a loan from a transfer pricing perspective, as it has been ‘capitalized’. You effectively might have loaned the money, but you capitalized it because there was no reasonable prospect to collect the cash based on the company’s individual earnings in Mexico.

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Taxation

What Happens in Mexico… is Taxed in the U.S.!

How the New FATCA Provisions Affect Mexican Residential Trusts

By Enrique Hernandez-Pulido, Esq. and Patrick W. Martin, Esq. (Procopio, Cory, Hargreaves & Savitch LLP)

We have previously commented on the potentially onerous U.S. reporting requirements involved with Mexican Residential Trusts (“MRTs”) held by U.S. persons[1] and have argued that because of the legal nature of MRTs under Mexican law, these type of arrangements should generally not be considered “foreign trusts” for U.S. tax purposes. Therefore, they should be granted an exemption from the reporting requirements of IRC Section 6048, or at least be subject to a “simplified” reporting system, so the argument goes, that would not carry the onerous penalties of IRC Section 6677. Unfortunately as of this date there has been no official response to this proposal. Indeed, the IRS has on a number of occasions asserted that MRTs are trusts, subject to these reporting requirements. Our office has seen increased enforcement activity by the IRS on this issue, including assessing penalties for failure to file IRS Forms 3520 and/or 3520-A.

The issue has recently become even more important with the change in the tax law. On March 18, 2010, President Obama signed into law the Hiring Incentives to Restore Employment Act (the “HIRE Act”). This Act includes a series of new international related provisions know as the Foreign Account Tax Compliance Act (“FATCA”).

FATCA includes various provisions that relate to “foreign trusts.” Importantly Section 533 of the HIRE Act amends IRC Section 643(i) so that the “uncompensated use” of trust property would be considered a taxable payment to a US person in an amount equal to the fair market value of the use of such trust property. A use by a related person to the U.S. person owner would also considered a taxable payment to such related person

In the context of a vacation property in Mexico, held by a U.S. person through an MRT (e.g., a house or condo in Los Cabos) through an MRT, this new law would tax the U.S. person on the fair market rental value of any time period he or she used the property during that year. Furthermore, if the property is used free of charge by a related person to the U.S. person owner (e.g. his or her children), then such related person would seem to be subject to tax based upon the fair market rental value of the property for its use.

Consider the following example: Mr. and Mrs. Smith, both U.S. citizens acquired a vacation condominium in Puerto Vallarta in 2006. Because they are not Mexican citizens and because the property is near the coast (i.e., within the zone where Mexican law restricts direct ownership of residential property by foreign persons), they took title to the condo through a Mexican “*fideicomiso*” (a MRT). Mr. and Mrs. Smith use the condo personally for approximately four weeks out of the year. They let Mrs. Smith’s sister use the condo for one week every year and Mr. Smith lets his business partner use it for another one week period every year. To offset some of the maintenance costs for the condo, Mr. and Mrs. Smith rent the property through a “vacation home rental” web service for approximately six to eight weeks each year at $150 USD a day for which they pay income and consumption/value added taxes in Mexico and income tax in the U.S.

Under the new law, the Smiths would have to include in their yearly taxable gross income $150 USD (assuming the same rate applies to any day of the year) for each day they use the condo. Assuming they are subject to a 30% effective U.S. income tax rate, then each day of use would effectively cost them out of pocket $45 USD in extra tax. Moreover, the “uncompensated” use by Mrs. Smith’s sister and Mr. Smith’s business partner seem to result in an extra US$2,100 of taxable income in the U.S.

($150 x 14). This would create additional U.S. federal income tax approximately $630 in federal taxes (considering the 30% effective rate). If the Smiths live in a state which adopts conformity to the new HIRE rules, they will have additional state income tax due and payable. It gets even more complicated for Mr. and Mrs. Smith. Since this "uncompensated use" is treated as a distribution from the foreign trust (the MRT) then Mr. and Mrs. Smith would be required to report such "distributions from a foreign trust" under IRC Section 6048(b) through IRS form 3520 (which is different from IRS Form 3520-A that they presumably are filing each year to report their interest in the MRT). Failure to timely and accurately file this form would expose Mr. and Mrs. Smith to penalties up to 35% of the "distributed" amount.

What are Mr. and Mrs. Smith to do about such complexity? Hiring international tax lawyers to advise on such transactions is not typically feasible or economically cost-effective for such a matter. Hopefully, their accountants and tax preparers have a fairly good understanding of these rules and how to keep them out of hot water by making the proper Mexican and U.S. tax filings. In the meantime, the international tax world gets increasingly complex and difficult for taxpayers who have international investments and activities, but not on the scale of a Fortune 100 company.

1 See: http://www.procopio.com/assets/002/5206.pdf

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CANADA

Investment

Upcoming G20 Meeting in Canada Presents an Opportunity for Canada to Join ICSID

By Andrew McDougall & Barry Leon
(Perley-Robertson, Hill & McDougall LLP/s.r.l.)

Canada's ratification of an important international treaty – the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States ("ICSID Convention") – is long overdue. Those of us who represent companies and governments in investor-state disputes have known for some time the protections and benefits that would be available to Canadians, and to foreign investors in Canada, once this international treaty is ratified. Already 145 other countries have ratified it. Canada has not, although it signed the Convention over three years ago.

The upcoming G20 meeting in Canada in June 2010 presents a perfect opportunity for Canada to join ICSID. By doing so, Canada would protect both international investment in Canada, making Canada a more attractive place for foreign investors, and Canadians who invest abroad.

ICSID is the International Centre for Settlement of Investment Disputes and it is the arbitration arm of the World Bank. It came into being 45 years ago through the signing of the ICSID Convention in Washington, D.C.

Over the past decade, prominent Canadian international arbitration and trade law practitioners, with support of senior Canadian business leaders, have attempted to persuade senior members of the governments and civil service in Canada why it is in Canada's interest to ratify the ICSID Convention. The subject of Canada's ratification of the ICSID Convention is now regularly raised within Canadian international arbitration and trade law organizations, such as the Canadian Chamber of Commerce and Canadian Bar Association. It is also regularly raised in public, such as at conferences like the 2009 joint McGill University/International Arbitration Institute conference on "15 Years of Nafta Chapter 11 Arbitration."

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As is made clear in its preamble, the ICSID Convention is focused on "the need for international cooperation for economic development, and the role of private international investment" and "the possibility that from time to time disputes may arise in connection with such investment between" a foreign investor and the state in which the foreign investor has invested.

The ICSID Convention establishes a widely accepted international method to settle investor-state disputes and provides for a binding agreement that an arbitral award rendered in such a dispute will be complied with.[1] Indeed, all member countries of the ICSID Convention are committed to recognize an ICSID arbitration award as binding and equivalent to a judgment of the highest court in their country. ICSID awards are not open to appeal and are subject to limited review only by a second ICSID tribunal rather than by any country's courts.

Perhaps there is no better evidence of the protections and benefits of the ICISID Convention than the fact that it has been widely accepted by the nations of the world. 156 countries have signed it, and of those, 145 countries have deposited their instruments of ratification. Until a country has both signed and ratified the ICSID Convention, the country is neither bound by nor able to take the benefits of being a party to it.

Given that the ICSID Convention has achieved such wide acceptance one would expect that Canada – a G8 and G20 country with a need for foreign investment and with so many businesses that invest internationally and engage in overseas projects – would be a party to it.

This is particularly so given that ICSID has been headed by a Canadian since mid-2009.

Canada did not sign the ICSID Convention until 41 years after the Convention was made. And even though it signed in December 2006, more than three years later Canada remains among a small minority of countries that have signed but not yet ratified the Convention.[2]

The upcoming G20 meeting in Toronto in June 2010 presents a perfect opportunity for Canada and its provinces and territories to remedy this.

Should Canada ratify the ICSID Convention, there are several key provisions that would be of advantage to Canadian international investors. Most significantly, investors would be able to take advantage of the important benefits of ICSID arbitration discussed above. They would be able to provide for ICSID arbitration in their contracts with any of the foreign states that are members of the Convention, and they would be able to bring international investment claims using ICSID where permitted in Canada's foreign investment protection agreements and free trade agreements. ICSID membership would contribute to Canada's reputation as a foreign investor-friendly country by giving foreign investors access to the protections and benefits of ICSID arbitration.

In order to ratify the ICSID Convention, constitutionally the Federal government and all Canadian provinces and territories must enact implementing legislation.

Canada's Federal government passed implementing legislation (the Settlement of International Investments Disputes Act[3]), and the legislation received Royal Assent on March 13, 2008. It has yet to be brought into force (for which an order of the Governor in Council is required), presumably pending the implementing legislation of the provinces and territories who have yet to enact the necessary legislation.

Only four of the ten provinces (British Columbia, Newfoundland and Labrador, Ontario, Saskatchewan) and one of three territories (Nunavut) have passed the necessary implementing legislation. Six provinces (Alberta, Manitoba, New Brunswick, Nova Scotia, Prince Edward Island, Quebec) and two territories (Yukon, Northwest Territories) have yet to do so.

Until the necessary implementing legislation is brought into force throughout the country, the ICSID Convention offers no protection to Canadian international investors or to foreign investors investing in Canada.

The lack of action on the part of Canadian provinces and territories may seem surprising given the amount of foreign investment in Canadian projects and the amount of Canadian money being invested abroad. Among the provinces and territories who have yet to enact legislation are ones that would benefit the most economically from the Convention.

Until the necessary implementing legislation is brought into force throughout the country, the ICSID Convention offers no protection to Canadian international investors or to foreign investors investing in Canada. Many of Canada's international trade agreements and investment treaties provide that disputes may be resolved through ICSID arbitration once Canada ratifies the ICSID Convention. However, until Canada ratifies the ICSID Convention, this option is not available.

Significant economic benefits for Canada are at stake. It is time for Canada to provide both international investors in Canada and Canadians with international investments

outside the country with the full protections and benefits that come with ICSID membership.

The upcoming G20 meeting in Toronto in June 2010 presents a perfect opportunity for Canada to complete ratification of the ICSID Convention and announce it to the world. Canada's federal, provincial and territorial governments should pull together now and do what is required to ratify the ICSID Convention.

1 The Convention is at: http://icsid.worldbank.org/ICSID/StaticFiles/basicdoc/CRR_English-final.pdf.
2 A list of signatories and ratifications is at: http://icsid.worldbank.org/ICSID/FrontServlet?requestType=ICSIDDocRH&actionVal=ShowDocument&language=English.
3 S.C.2008, c.8.

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***Foreign Investment**, from page 1*

on foreign investment be relaxed. The Canadian government moved to implement some of these recommendations in 2009, most notably by revising certain thresholds in the *Investment Canada Act* to reduce the number of transactions that would be subject to review under that legislation (although the most important of these changes is still not yet in force).

Two recent developments now indicate that changes to sector-specific rules governing foreign investment may also be on the horizon.

First, the federal government announced plans on March 3, 2010 to liberalize foreign investment restrictions affecting the telecommunications and uranium sectors. The government positioned this proposal as part of a broader campaign to promote free trade, innovation and the development of a skilled and educated workforce.

In another recent development, Amazon has applied to expand its operations in Canada. The government's decision in this matter could affect the potential scope for investment in "cultural industries" by non-Canadians, another area of the Canadian economy that is currently governed by rules restricting foreign investment.

These developments are discussed below.

Telecommunications

In order to be eligible to operate as a "telecommunications common carrier" in Canada, a company must meet the following requirements set out in the *Telecommunications Act*:

- at least 80% of its directors must be Canadians;
- Canadians must own at least 80% of its voting shares (a corporate shareholder must be 2/3 Canadian-owned in order to qualify as Canadian); and
- it must not otherwise be controlled-in-fact by non-Canadians.

The issue came to the fore most recently when the *Canadian Radio-television and Telecommunications Commission* ("CRTC") had to determine if Globalive Wireless Management Corp. ("Globalive"), a proposed new entrant to the Canadian wireless market, satisfied the *Telecommunications Act* requirements. In October 2009, the CRTC ruled that Globalive was controlled in fact by Orascom Telecom, a non-Canadian, and therefore was not eligible to provide wireless services in Canada. Globalive appealed the decision to the federal Cabinet, which overruled the CRTC and permitted Globalive to begin offering its mobile telephone services to Canadians.

The Canadian government emphasized that its decision to overrule the CRTC did not represent a shift in policy governing foreign investment in the Canadian telecommunications sector. However, most observers believed that the Globalive decision signalled the government's intention to liberalize the foreign investment rules for telecom. These suspicions were confirmed with the government's announcement in its "Speech from the Throne" on March 3 (the equivalent of the U.S. "State of the Union" address) that it intends to "open Canada's doors further to venture capital and to foreign investment" in the telecommunications sector, "giving Canadian firms access to the funds and expertise they need." Notably, the government did not indicate any similar intention to open up the Canadian broadcasting sector to greater foreign investment (current foreign control rules for broadcasting are similar to those for the telecom sector.)

The government's announcement regarding foreign investment in the telecom sector did not offer any details

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beyond the above statement of intent. However, in comments made after the Speech from the Throne, Canada's Minister of Industry seemed open to allowing non-Canadians to acquire full control of telecommunications companies, subject only to the standard "net benefit to Canada" and "not injurious to national security" tests in the *Investment Canada Act*.

Another possibility, short of removing all restrictions on foreign ownership, is that non-Canadians only be permitted to control start up telecom companies, or acquire control of existing companies with a small market share (e.g., under 10%), as a way of encouraging new entry and competition. (The Competition Policy Review Panel recommended this as an initial step subject to further liberalization after five years.)

We will now have to wait for the proposed amendments to the *Telecommunications Act* to see how far the Canadian government is willing to go and whether the proposal is capable of gaining majority support in Canada's Parliament (where no party currently holds a majority of seats). Matters may become clearer after a Parliamentary committee holds hearings into the issue later this year. The committee will be reviewing a variety of questions relating to foreign investment in Canada, including whether or not to allow greater foreign control of Canadian telecom companies.

Uranium

The March 3 Speech from the Throne also set out the Canadian government's intention to loosen foreign ownership restrictions affecting uranium mining: "While safeguarding Canada's national security, our Government will ensure that unnecessary regulation does not inhibit the growth of Canada's uranium mining industry by unduly restricting foreign investment".

Pursuant to current Canadian government policy, non-resident ownership of uranium mining properties is restricted to 49% at the stage of first production. Higher levels of ownership are permitted if it can be demonstrated that the project remains Canadian-controlled. There are no restrictions on uranium exploration by foreign entities.

In addition to the foregoing restrictions, there is also specific federal legislation limiting foreign ownership of Cameco Corporation, a Saskatchewan-based company which is one of the two largest uranium mining companies in the world. No single non-resident can own more than 15% of Cameco's shares and total foreign ownership cannot exceed 25%. Federal and provincial legislation also mandates that Cameco's head office be maintained in the province.

The Canadian government had previously stated its intention to increase foreign ownership limits in uranium mines, provided that Canada is able to negotiate reciprocal benefits with potential investor nations and that any foreign investment in this sector is not contrary to Canadian national security. The statement in the Throne Speech indicates that the Canadian government intends to follow through with its goal of relaxing uranium mine ownership restrictions. Again, however, the precise nature of the government's plans remain unclear.

Amazon/Book Distribution

Canadian "cultural" industries – such as book publishing and distribution – are another protected segment of the Canadian economy. Special rules apply to cultural industries in the *Investment Canada Act* and the Canadian government has issued various policies augmenting the requirements of that legislation.

The federal government announced plans on March 3, 2010 to liberalize foreign investment restrictions affecting the telecommunications and uranium sectors. The government positioned this proposal as part of a broader campaign to promote free trade, innovation and the development of a skilled and educated workforce.

A recent proposal by Amazon to expand its book distribution operations in Canada has focussed new attention on the restrictions against foreign control of Canadian cultural industries.

The Minister of Canadian Heritage is generally authorized under the *Investment Canada Act* to review acquisitions by non-Canadians of Canadian cultural businesses as well as the establishment by non-Canadians of new cultural businesses in Canada. The Canadian government also has a specific policy governing foreign investments in the book industry, which provides that non-Canadians (a) may not establish new book distribution businesses in Canada, but are limited to investing in Canadian-controlled joint ventures; (b) are prohibited from acquiring Canadian-controlled book distribution businesses other than in exceptional circumstances; and (c) may only acquire control of Canadian book distribution businesses already owned by non-Canadians if the Minister is satisfied that the acquisition is of "net benefit

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to Canada". To obtain the latter type of approval, non-Canadian investors will typically be expected to offer commitments to support Canadian authors and the Canadian book industry (among other things).

In 2002, Amazon was able to persuade the Canadian government that the *Investment Canada Act* did not apply to its plans to begin sales into Canada, on the grounds that Amazon would not have a physical presence in Canada. Instead, Amazon proposed to contract out the required warehousing and distribution functions in Canada to a subsidiary of Canada Post, the government-run postal service. As a result, Amazon was able to begin operations in Canada unencumbered by any commitments with respect to the Canadian content of the products it offered.

It now appears that Amazon wants to change its business model for cost-saving reasons, and is proposing to establish its own fulfillment centre in Canada to handle orders and distribution (Amazon Fulfillment Services Canada Inc.). Accordingly, the matter is once again before the government of Canada, and specifically the Minister of Canadian Heritage. The Minister must decide if Amazon's plan to move from a virtual to physical presence will be of "net benefit to Canada" and consistent with the government's policies on book distribution in Canada. Amazon's proposal to establish a distribution arm in Canada is opposed by the Canadian Booksellers Association, which claims the move is a threat to the Canadian bookselling industry and Canadian culture. The CBA tried to stop Amazon's entry into Canada in 2002, but lost a court case challenging the government's decision not to take action.

The matter is likely to be decided within the next several months and could indicate if the government intends to seize upon the Amazon case as a way of opening up Canadian cultural industries to foreign investment, in the same way that it seems poised to use the Globalive case as a wedge to open up the Canadian telecom industry to non-Canadians. However, since cultural industries are far more of a hot button protectionist issue in Canada than cell phones, the government may very well decide to refrain from dramatic moves affecting the sector at this time.

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REGIONAL

***Technical Barriers**, from page 1*

can only be expected to proliferate. The challenge for exporters in this ever more complex environment is twofold: first, positioning themselves and their products or services to be able to meet the growing technical demands that regulations and standards impose without affecting competitiveness; and second, preventing local competitors from using technical regulations as trade barriers to your exports. This article discusses the latter one.

International trade agreements such as the World Trade Organization's (WTO) Agreement on Technical Barriers to Trade (TBT Agreement) and the North American Free Trade Agreement's (NAFTA) Chapter Nine on Technical Barriers to Trade[1] seek to balance the development of TBTs that have an impact on open and harmonized international trade, with the rights of individual governments to decide how best to safeguard their population and environment from what they consider substandard products and services. Interestingly, the ways the WTO and NAFTA handle this balancing act differ in material ways and knowing these differences is useful in planning exports to North America. This article seeks to provide information about TBTs and what exporters should consider in order to keep their products and services compliant and competitive in North America.

A Few Basics About TBTs

There are a few basic concepts that exporters must know to properly navigate through any technical regula-

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tion issues. These basic concepts will allow an exporter to assess TBTs and, if necessary, exercise their rights under international trade agreements. These concepts are:

A. ***Technical Barriers to Trade (TBTs):*** TBTs are laws or regulations requiring that a product or service conform to a specified standard of quality, performance, safety or dimension as a condition for importation.

B. ***Standards and Technical Regulations:*** the two basic types of TBTs. The difference between them lies in that standards are voluntary and technical regulations are mandatory. Products that fail to meet the requirements of a technical regulation cannot be sold in the import market. Products that do not meet an applicable standard may be sold in the import market, but they will compete at a disadvantage with products that meet the standard (particularly if the difference is well advertised). Standards can be based on a variety of factors such as color, quality and even a product's production process. Because of their voluntary nature, standards may seem less of a threat to exports, but these should not be underestimated. Standards can be developed into powerful commercial weapons because they are easier to create and may be harder to question.

C. ***Conformity assessment procedures:*** technical procedures—such as testing, verification, inspection and certification—which confirm that a product meets the requirements set forth in technical regulations or standards. Conformity assessment procedures may create problems to exporters if they are too costly, slow, discriminatory or if they fail to be transparent.

D. ***Standards Related Measures (SRMs):*** include *technical regulations*, *standards* and *conformity assessment procedures*. SRMs are in essence the instruments that may affect an export's market access and competitiveness.

E. ***Risk assessment:*** the process undertaken by the importing government prior to the development and implementation of an SRM to determine whether the SRM has an adverse effect on trade.

Using these concepts we first evaluate below how NAFTA regulates TBTs and then we propose five steps to navigate TBTs under NAFTA.

Is NAFTA Pro Environment?

All three NAFTA governments apply a variety of technical regulations and standards that affect products sold and consumed in their countries. If you are considering exporting a product or service to a NAFTA country it is likely that, at some point, your export may be subject to technical regulations. NAFTA is somewhat peculiar when it comes to technical regulations in that it does not enthusiastically embrace the WTO's priority of more harmonized, freer flowing trade over the development of excessive technical regulation. The TBT Agreement makes a clear and substantive effort to limit a member's ability to develop technical regulations that could be more trade disruptive then they really need to. The NAFTA, conversely, comes out swinging clearly in favor of the environment, consumer safety and even product quality as a priority over global trade. For those who believe that NAFTA cannot properly protect the environment, a good read of its Chapter Nine should dissipate that idea.

While the TBT Agreement emphasizes the importance of applying international standards as a way of keeping all nations following the same rules, and thereby facilitating international trade, NAFTA has no quarrel allowing its signatories to adopt *any* SRM "that results in a higher level of protection" than would be required by the relevant international standard. Under a NAFTA frame of mind, as long as the technical regulation can claim to pursue a "legitimate objective" and said regulation does not unjustifiably carve out domestic products to target imports, there is no limit as to how high the bar may be raised or how complex its implementation may be, and consequently how expensive or trade disruptive it can be.

All three NAFTA governments apply a variety of technical regulations and standards that affect products sold and consumed in their countries.

Further, NAFTA's definition of "legitimate objective" is more comprehensive than the one used by the WTO. Both the WTO and NAFTA specifically set forth the protection of human, animal, plant life, the environment and consumers as legitimate objectives. NAFTA, however, also expressly includes "matters relating to quality and identifiability of goods or services"[2] in its definition of the concept. This language makes it harder to stop a government from developing technical regulations on the basis of selected quality characteristics that may conveniently take a swipe at certain imports. Likewise, setting forth "identifiability" as a "legitimate objective" leaves the door open to developing aspects of a technical regulation based on factors related to origin, nature and special characteristics,[3] which could also be discreetly targeted at imports.

NAFTA also makes a point of adding "safety" and "sustainable development" as legitimate objectives, and

it is not clear how comprehensive these objectives may be for purposes of technical regulations. NAFTA does not relate the word "safety" to anything in particular (*e.g.* human safety) and provides no definition for either of these terms. A dictionary definition of "safety" is "freedom from danger, risk or injury."[4] Using this definition any local authority could arguably create a TBT based on its assessment of what is safe from any perspective in relation to any product or service, which could lead to unnecessarily high standards of safety without regard to the effect on commerce.

The term "sustainable development" was defined by the United Nation's World Commission on Environment and Development as development that "meets the needs of the present without compromising the ability of future generations to meet their own needs."[5] One can only stop to ponder how many products today meet this standard. Those that don't could be subject to technical regulation in the NAFTA region.

Even though NAFTA is quite tolerant of TBTs we see no evidence that the overall number of SRMs negatively affecting imports is substantially higher than in other trade regions.

An additional aspect that makes NAFTA different from the WTO's TBT Agreement is NAFTA's relaxed use of risk assessments and science as methods to justifying a technical regulation. The TBT Agreement not only requires its Members to assess the risks that non-fulfillment of a particular legitimate objective can have on the environment, health, life etc., but it also considers scientific evidence to be relevant when assessing those risks. Under NAFTA Article 907 governments "*may*" assess the risk of non-fulfillment of a legitimate objective and "*may*" use scientific information available to assess those risks. For a NAFTA country this means, first, that figuring out whether a draft technical regulation may be trade disruptive is optional. It also means that even when there is scientific evidence that a regulation is *not* necessary to meet a legitimate objective, NAFTA countries are not obligated to consider that evidence, if there are other factors that can be used to justify a particular SRM, such as "intended end uses," "processes of production" and "environmental conditions," or any other factor relating to the good or service being considered that the NAFTA importing government chooses to use.

Five Steps to Navigate NAFTA TBTs

Clearly, NAFTA provides fertile ground for TBTs. But NAFTA does demand that governments meet important requirements before they can establish a TBT. For an exporter understanding and even demanding the proper application of these requirements may be the difference between getting shut out of the market or entering it competitively. Based on these requirements below we provide 5 steps exporters can take to avoid a TBT from becoming an unfair trade barrier:

First: Participate in the development of the SRM (and be aware of the short deadlines)

NAFTA obligates its Members to notify, publish and provide information about existing and potential SRMs. According to NAFTA Article 909 a government must provide notice of any intended adoption or modification of a "technical regulation" at least 60 days prior (30 days for perishables) to taking any action. There is no set notification period for voluntary "standards" except that notice in these cases has to be "at an early appropriate stage." Between the notice and the expected date of issuance of the SRM, the NAFTA government issuing the proposed regulation must consider all interested party comments regarding the proposed SRM. If the developing SRM threatens to become an unfair trade barrier exporters and producers have this brief period to organize themselves and seek the assistance of their NAFTA government(s). Presenting comments about the proposed SRM as a group will be a more effective tool than sending individual, potentially contradicting comments. Even minor text changes, which officials may not think twice about, could have an important effect on an exporter's costs. Additionally, if the foreign market is important enough exporters would be wise to have someone on the ground to monitor potential legal developments with both government agencies and industry associations. Coming to a SRM debate early can make the difference between a regulation you can work with, and even exploit commercially, to one that leaves you out of the market.

Second: Make sure that the SRM is made pursuant to a legitimate objective.

Both NAFTA and the WTO state that SRMs should not be "prepared, adopted, maintained or applied with a view to or with the effect of creating an unnecessary obstacle to trade."[6] NAFTA, however, further provides that "an unnecessary obstacle to trade shall not be deemed to be created where the demonstrable purpose of the measure is to achieve a legitimate objective".[7] Under NAFTA therefore, the development of technical regulations will trump trade as long as a legitimate objective is being

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pursued. In principle, this is appropriate as it is generally accepted that trade should give way to the protection of the environment and other legitimate objectives. The concern, however, is that given NAFTA's definition of "legitimate objective", which is both ambiguous and comprehensive, the development of an SRM with very high and even unreasonable standards, as long as it can claim to pursue a legitimate objective, is not out of the question.

Given NAFTA's permissive language, attacking a SRM for being an obstacle to trade may be a dead end. The regulation or standard in question under NAFTA is tested not by how disruptive it can be to trade, but whether the objective the SRM pursues is legitimate. If confronted with a potentially trade-damaging SRM it may be useful therefore to seek the assistance of the export government and experts to determine whether in fact the SRM meets the objective it was created for or whether there is another effective, less trade disruptive way to meet that objective.

Third: Ask your NAFTA government to demand compatibility or equivalence

NAFTA requires that countries, "to the greatest extent practicable," make their SRMs compatible to avoid having manufacturers and service providers meet different regulations to reach the same legitimate objective. What is "practicable" may not always be easy to define and remains discretionary for each government. Because a technical regulation may serve as an effective trade barrier domestic industries (and consequently their governments) may not always seek compatibility, particularly if NAFTA competition is fierce. There is little in NAFTA to stop a politically motivated government from using, adjusting or even raising protection levels (assuming that all or its most relevant producers can meet the new levels) to block any attempt at compatibility, as long as it can claim that it is doing it pursuant to a legitimate objective which, under NAFTA, may not be difficult to do.

Conversely, if competition is not fierce between industries it is possible and it may make sense for exporters to argue for the "equivalence" of different technical regulations that regulate the same products or services to reach a common objective. Under NAFTA Article 906.4 an importing NAFTA Party has discretion to accept another NAFTA Party's technical regulations as sufficient if it can be convinced that said technical regulation adequately fulfills its legitimate objective.

Fourth: Cry "foul" if the SRM is made to affect, or is affecting, only you or competitors like you

The last requirement that SRMs must meet is set forth in NAFTA Article 904.3, which establishes that SRMs must be applied and created on a *non-discriminatory* basis. SRMs must be compatible with the principles of National Treatment and Most Favored Nation ("MFN") Treatment. That is, the regulations should not discriminate based on the origin of the product, so for example, any technical regulation that is created to safeguard the quality of tomatoes should apply equally to all tomatoes produced locally and to the tomatoes imported from all countries.

If it is evident that the language targets imports in general or a very specific group of imports that include your products or services you should discuss with your NAFTA government the possibility of making a claim that the SRM in question transgresses the National or MFN treatment obligations under NAFTA. The requirement that SRMs not be discriminatory is potentially the best argument one can build upon to fight an unfair TBT.

Fifth: Move your production for delivery to North America from North America.

It may sound peculiar, but if: a) the actions described above will not work, b) it is evident that the SRM is unfair or too high to meet a legitimate objective, and c) the North American market is important enough, you should consider moving at least a part of the production outside North America to a third country that is a member of WTO and export from there to the target NAFTA country. The reason is that the standard to develop SRMs between NAFTA signatories is higher than between a NAFTA signatory and a non-NAFTA one (as long as said non-NAFTA signatory is a member of WTO). From there you may be able to fight the measure based on the WTO standard which is better grounded to determine the legitimacy of the objectives and properly balance the need for trade with the need for safety and protection. Notably, under Article 2005.4 of NAFTA any NAFTA Party can require that any SRM dispute it may have with another NAFTA Party be resolved solely within NAFTA, as opposed to having the matter resolved at the WTO where most trade disputes involving NAFTA parties have been resolved. Clearly, NAFTA negotiators understood that without this NAFTA exclusive jurisdiction provision the more protectionist NAFTA-safe SRMs would be swiftly shot down under the WTO.

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Final Comments

Interestingly, even though NAFTA is quite tolerant of TBTs we see no evidence that the overall number of SRMs negatively affecting imports is substantially higher than in other trade regions. Perhaps NAFTA negotiators thought that making it easier to create technical regulations would not necessarily mean that these would actually be created. In this attorney's opinion the requirement that regulations be developed in a non-discriminatory manner is the most important reason why SRMs are not popping up more often as trade barriers and perhaps the strongest tool exporters may apply to avoid market blockage. The NAFTA based SRMs that do appear may not be leading to disputes because those potentially most affected by the measures, the small and medium size companies, do not have the funds, time or capacity to question SRMs and in a globalized world it may be easier to move their production to other markets, such as China, that are not subject to NAFTA's higher standards. The final reason why more TBTs are not being created may be that industries seeking protection from imports have not quite discovered the flexibility that NAFTA provides in the development of technical standards which could end up effectively blocking foreign competitors. Even though some industries, such as the U.S. tuna industry with its dolphin-safe standard have successfully used NAFTA Chapter 9 to target certain imports coming into the United States, no clear precedent has been set as to how to effectively create justifiable trade barriers through technical regulations. Perhaps a road to developing NAFTA-proof TBTs will never come to fruition. One thing is for certain however, there are difficult times ahead in all the areas where technical regulation may arise: the environment, food safety, consumer protection, human, animal and plant life. There is no doubt that we will be seeing more and more technical regulations in North America and it will be up to NAFTA exporting companies to keep their ear to the ground and be ready to act and prevent real and legitimate SRMs from becoming questionable, trade-blocking measures.

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1 Note that Article 901 NAFTA provides that Chapter Nine does not apply to measures to Sanitary and Phitosanitary Measures of Chapter Seven.
2 NAFTA Article 915.
3 NAFTA does not provide a definition for "identifiability" but *see* The American Heritage Dictionary, Third Edition, Dell Publishing, 1994, which defines the term identify as "[t]o ascertain the origin, nature, or characteristics of."
4 The American Heritage Dictionary, Third Edition, Dell Publishing, 1994.
5 *Report of the World Commission on Environment and Development: Our Common Future*, also known as the Brundtland Commission, was convened by the United Nations in 1983. The report was transmitted to the General Assembly as an Annex to document A/42/427 *- Development and International Co-operation: Environment.*
6 *See* NAFTA Article 904.4.
7 The WTOs requirements in this area are harder to meet. Article 2.5 of the TBT Agreement provides that there is a "rebuttable presumption" (as opposed to NAFTA which does not allow for any kind of rebuttal) that a technical regulation does not create an unnecessary obstacle to international trade when it is "prepared, adopted or applied" pursuant to a legitimate objective *and* is in accordance with relevant international standards.

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