NAFTA and the Digital Economy:

A Case for Targeted Revisions to Strengthen the Trading Bloc by Reducing Barriers Affecting Digital Services and Increasing Protection of Intellectual Property Rights

by

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I. INTRODUCTION

When the North American Free Trade Agreement (NAFTA) entered into force in 1994, businesses involving current applications of modern technology such as online marketplaces, the cloud, the app economy, artificial intelligence, precision agriculture, and machine learning, were not part of an enterprise's business operations. Today, hundreds of thousands of businesses use the internet to directly access customers in North America and around the world. The United States is a global leader in digital trade with a $159 billion trade surplus in digital trade,[3] Canada is home to a thriving digital media industry that employs over 50,000 employees and generates USD 5.9 billion in annual revenue,[4] and according to the Mexican Internet Association's latest available data, the Mexican e-Commerce market had a value of USD 16.2 billion in 2015 and grew at an annual rate of 59 percent.[5]

Exporters within the U.S., Mexico, and Canada (the NAFTA Member States) are leveraging internet-enabled tools, such as e-commerce, to connect with customers in nearly every foreign market in the world. A modernized NAFTA would help the United States, Mexico, and Canada maintain and build on this leadership. The renegotiation of NAFTA is an ideal opportunity to set the gold standard for digital free trade.

The 21st century data economy relies on software services ranging from cloud computing to data analytics, and will increasingly use artificial intelligence services and blockchain technologies. These technologies and services are most effective when data can flow seamlessly across borders. In its negotiations with Canada and Mexico, the U.S. should seek rules limiting data localization, promote a balanced approach to intellectual property (IP) protections, and remove barriers that hinder the trade of services.

Though NAFTA focuses on eliminating barriers to trade and investment including the elimination of certain tariffs on exports between the U.S., Canada and Mexico, income tax considerations constitute a significant concern affecting cross-border activities and investment. Intended to increase investment and avoid double taxation for taxes on income, the U.S. has income tax treaties in force with Mexico and Canada. Each of these treaties was separately negotiated, and both provide for certain benefits for qualified residents such as the reduction of withholding taxes applicable to dividend, royalty, and interest income that would otherwise apply to persons under the statutory laws of the relevant jurisdictions.

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[3] U.S. Department of Commerce, Economic and Statistics Administration. "Digitally Deliverable Services Remain an Important Component of U.S. Trade." http://esa.doc.gov/economic-briefings/digitally-deliverable-services-remain-important-component-us-trade.
[4] Government of Canada, Canadian Trade Commissioner Service. "Digital Media" http://www.international.gc.ca/investors-investisseurs/sector-secteurs/digital_media-media_numerique.aspx?lang=eng (last accessed October 22, 2017).
[5] Export.gov. Mexico Country Commercial Guide. "Mexico e-Commerce" https://www.export.gov/article?id=Mexico-ECommerce (last accessed October 22, 2017).

Income tax benefits intended to encourage trade and investment are a critical component of the considerations a multinational enterprise analyzes to determine investment strategy, and any benefit to be derived is significantly hindered by the absence of rules among the NAFTA Member States that encourage and protect relevant rights for digital free trade. A company may choose to structure its cross-border operations in a way to protect its data and IP rights at the cost of foregoing a potentially more beneficial structure from an income tax perspective.

This article suggests that NAFTA should not only include an e-commerce chapter to protect IP rights of multinational enterprises but also seek to complement the existing income tax benefits under the relevant income tax treaties by removing barriers that hinder the trade of digital services. And the improvements to the NAFTA provisions with respect to digital trade could act as an impetus for tax authorities and legislators to provide much-needed guidance with respect to taxation of digital goods and services. In that manner, a multinational enterprise will be in a better position to structure operations in ways that make economic and functional sense by eliminating customs duties on digital trade without undue risk to a company's IP while at the same time allowing the company to benefit from local tax rules within the respective NAFTA Member States and provisions of the relevant income tax treaties that potentially lower the income tax expense and encourage trade and investment among the Member States.

II. GENERAL INCOME TAX CONSIDERATIONS RELATED TO IP

Intellectual property can constitute one of the more valuable assets a company owns, particularly for a company in the technology industry. IP can be made up of a variety of property items such as patents, copyrights, trademarks, software, know-how, and processes.

Digital services often arise as an offering of a company in the technology industry. Digital services are services that can be delivered through an information infrastructure, such as the internet. They include the delivery of digital information (i.e. data or content) and transactional services (e.g., online forms, benefits applications) across a variety of platforms, devices and delivery mechanisms (e.g., websites, mobile applications, and social media).

Consider, for example, Company A, a provider of multi-screen video advertising technology, which connects brand advertisers, digital media property owners and consumers of video content across a range of Internet-connected devices. The Company A technology platform is designed to serve specific needs of brand advertising to deliver digital video advertising campaigns.

Company A's software platform is the technology through which it offers its digital advertising services. Company A owns this software platform and is a U.S. parent company with Canadian and Mexican subsidiaries that contract in their respective jurisdictions with local customers to provide access to the software platform.

From this simplified description of Company A's group operations, a number of cross-border income tax issues arise. From a U.S. tax perspective, there is the issue of the characterization of the income streams of Company A and the resulting consequences such characterizations have on income tax liabilities.

For example, if Company A's activities generate services or royalty income, there could be different tax consequences if such income is considered derived from Canada or Mexico. If, under its operating model, the applicable income tax rules consider Company A to derive services income from Mexico, the question becomes where the services were provided. From a U.S. tax perspective, services provided in the U.S. are generally subject only to U.S. income tax, regardless of payment made by customers located in Mexico.[6] By contrast, if Company A's activities generate royalty income from its subsidiaries or customers in Mexico and Canada, such royalties are generally considered derived from where the IP is used (i.e., in Mexico or Canada) and subject to local income tax on payments to Company A.[7]

Royalties from Canada are generally subject to a 25% withholding tax on payments to nonresidents. Likewise, royalties from Mexico would generally be subject to a withholding tax of 25% or 35%, depending on the type of property considered to generate the royalty. Thus, the characterization of income streams derived from operations becomes critical to the income tax expense Company A will incur.

Where withholding taxes do apply, Company A has the opportunity to look to income tax treaties that the United States has in effect with various countries, including Canada and Mexico, that aim to reduce the potential for double taxation and offer other benefits such as reduced withholding on dividends, royalties, and interest payments between qualified residents of treaty countries. For example, the royalties from Mexico mentioned above would generally be subject to a withholding tax of 25% or 35% under local rules in Mexico. However, the U.S. – Mexico Income Tax Treaty provides for a reduced withholding rate of 10% on royalties paid from Mexico to qualified U.S. residents,[8] lowering the tax expense and costs of doing business in Mexico. Each income tax treaty is separately negotiated, and in the case of Canada, the U.S. – Canada Income Tax Treaty provides for a reduced withholding rate of 0% or 10% on royalties paid from Canada to qualified U.S. residents.[9]

Furthermore, functions and risks assumed within a multinational group's operations generally correlate directly to the amount of taxable revenues, and tax authorities will look to this relationship in assessing the need to adjust a company's reported income for tax purposes. For example, if Company A's Mexican subsidiary acted as a reseller of access to Company A's software platform within the Mexican market, the reseller function generally involves the assumption of fewer economic risks. Instead, if the Mexican subsidiary functioned as an entrepreneur, it would own the rights to the IP platform within the Mexican market and would be responsible for the IP's further development and providing access to the software platform within that market. Accordingly, tax authorities would generally expect to find a lower compensation base for a reseller compared to the percentage of revenues attributable to an entrepreneur.

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[6] I.R.C. §§ 861(a)(3), 862(a)(3).
[7] I.R.C. §§ 861(a)(4), 862(a)(4).
[8] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Mex.., art. 12, Dec. 28, 1993.
[9] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Can., art. XII, Aug. 16, 1984.

Income tax issues in different jurisdictions represent one consideration a multinational company will face in its cross-border activities. And the decision to assign risks and functions to a particular entity in the corporate group is a balance between the income tax consequences and the operational considerations of the multinational company. A lower income tax rate in one jurisdiction does not necessarily mean operations will be placed there if there are operational or other business challenges that carry a financial cost or business detriment that a company cannot assume.

For example, if Company A determines that it will transfer software rights to its Mexican subsidiary for doing business in the Mexican market that would create certain tax efficiencies from a global tax perspective, but faces the loss of certain legal protections from the transfer of that IP, any income tax benefit may be lost from Company A's determination that the loss of certain legal protections is too significant a business risk. To put these considerations in more context, it may be helpful to consider NAFTA's history and IP-related provisions concerning rights that affect the digital economy.

III. NAFTA: CURRENT STATE OF IP AND DIGITAL TRADE PROVISIONS

Background

NAFTA came into effect in 1994, well before the advancements of the e-commerce industry. The services and goods available through digital trade did not exist when NAFTA was first drafted; nor was its abrupt global impact expected. NAFTA has not adequately addressed the issues facing the digital economy and has inadvertently allowed for the restriction of digital trade in goods and services.

On July 17, 2017, the Office of the U.S. Trade Representative ("USTR") issued its notice letter outlining its objective to renegotiate NAFTA to include adding a digital economy chapter.[10] The hope is that the outcome of these negotiations will ultimately eliminate the current barriers to digital trade and cross-border data flows, remove current data localization requirements, and address data privacy protections and intellectual property-related concerns.

Current IP-Related NAFTA Provisions

IP protections under Chapter 17 of NAFTA afford IP owners certain protections. Specifically, NAFTA:

- Establishes minimum standards of IP protection, based on the principles set out in the major international IP conventions, and requires the enforcement of these standards.

- Requires effective enforcement of IP rights at the borders of NAFTA Member States to ensure that IP rights holders are protected from infringement by imported products.

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[10] U.S. Trade Representative, Summary of Objectives for the NAFTA Renegotiation ("USTR NAFTA Summary") p. 8, https://ustr.gov/sites/default/files/files/Press/Releases/NAFTAObjectives.pdf (last accessed July 19, 2017).

- Establishes a dispute-settlement procedure with trade-related sanctions and, in some cases, damages payable to IP holders, to provide effective recourse against infringements of IP rights.

Chapter 17 further addresses copyright, trademarks, patents, enforcement rules, and border measures. These protections are extended to digital goods, under Chapter 11, Article 1139, whereby IP rights are defined under investment as "other property, tangible or **intangible**, acquired in the expectation or used for the purpose of economic benefit or other business purposes…". It should be noted that not all protections afforded under Chapter 17 cover Chapter 11 intangibles. However, for the purposes of this article, suffice it to state that the protections afforded under Chapters 11 and 17 do not fully address the issues that arise in digital trade transactions.[11]

IV. NAFTA LIMITATIONS: IP AND DIGITAL TRADE IN GOODS AND SERVICES

Because NAFTA does not address digital transactions, local barriers have developed which have resulted in the segmentation of digital trade. Since 2011, the U.S. International Trade Commission ("USITC") estimates that digital trade increased U.S. GDP by between $517 billion and $711 billion, increased wages by 4.5 to 5.0 percent, and was the catalyst for the creation of up to 2.4 million jobs.[12] The USITC estimates that the removal of foreign barriers to trade (e.g., in-country data storage requirements and privacy regulations, to be discussed further) would likely result in a $16.7 billion to $41.1 billion increase in U.S. GDP, and U.S. real wages would likely be 0.7 to 1.4 percent higher.[13] Per the USITC, the elimination of barriers to digital trade in goods and services will ultimately increase GDP and wages in the U.S.

Non-enforcement of IP owner's rights under NAFTA

As mentioned above, NAFTA's IP provisions provide minimal protections to digital trade in goods and services and domestic laws have resulted in further jeopardizing IP owners' rights. According to the USTR NAFTA Summary, multiple amendments should be passed to ensure IP protections meet the current state of digital trade. The USTR NAFTA Summary suggests that NAFTA IP rights should parallel the standard of protection imposed by the U.S and implement the World Trade Organization Agreement on Trade-Related Aspects of Intellectual Property Rights ("TRIPS"), particularly with respect to meeting enforcement obligations under TRIPS.[14]

The USTR NAFTA Summary also provides suggestions to strengthen IP rights under NAFTA, which include stronger protection and enforcement for new and emerging technologies, and new methods of transmitting and distributing products containing IP in a manner that facilitates

[11] *See, generally*, Robert Lighthizer, May 18, 2017 Notice Letter to Congressional Leaders, https://www.ip-watch.org/weblog/wp-content/uploads/2017/05/2017.05.18-NAFTA-Congressional-Notification-4-Leaders.pdf?0c235b (last accessed October 22, 2017). Mr. Lightizer's letter outlines the limitations found in NAFTA as they relate to IP rights and digital trade.

[12] U.S. International Trade Commission. "Digital Trade in the U.S. and Global Economies, Part 2" https://www.usitc.gov/publications/332/pub4485.pdf (last visited October 23, 2017).

[13] *See id.*

[14] USTR NAFTA Summary at pp. 9-10.

legitimate digital trade and the prevention or elimination of discrimination with respect to IP rights.[15]

Digital Trade and Data Localization, Privacy and Other Barriers

Additionally, data localization laws have increased barriers to digital trade in goods and services. Data localization includes policies that require in-country location of data servers, policies that require local content or technologies, and government procurement preferences and standards that favor local government.[16] Internet communication service providers and e-commerce companies may find it hard to maintain operations in countries that make data localization a condition of market access.[17] When governments require processing or storing data in-country, or restrict cross-border data flows, the complexities and costs effectively exclude some firms from commerce.

V. TRANS-PACIFIC PARTNERSHIP AGREEMENT AS A STARTING POINT TO INCLUDING A DIGITAL GOODS AND SERVICES CHAPTER TO NAFTA

On July 17, 2017, the USTR released its summary of objectives for NAFTA renegotiations. It provided four objectives revolving around digital trade and cross-border data flows, which include the following:

1. "Secure commitments not to impose customs duties on digital products (e.g., software, music, video, e-books);

2. Ensure non-discriminatory treatment of digital products transmitted electronically and guarantee that these products will not face government-sanctioned discrimination based on the nationality or territory in which the product is produced;

3. Establish rules to ensure that NAFTA countries do not impose measures that restrict cross-border data flows and do not require the use or installation of local computing facilities; and

4. Establish rules to prevent governments from mandating the disclosure of computer source code."[18]

Many of the concerns and objectives provided by the USTR are outlined in the 2016 proposed Trans-Pacific Partnership Agreement ("TPP"). Chapter 14, Electronic Commerce, Article 14.13, states member countries are prohibited from requiring persons to use or locate data servers in its country as a condition for conducting business in that country.[19] The TPP agreement further provides additional provisions in resolving barriers to digital trade. The only limitation to the flow

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[15] *See id.*
[16] *See, generally*, U.S. International Trade Commission. "Global Digital Trade 1: Market Opportunities and Key Foreign Trade Restrictions" https://www.usitc.gov/publications/332/pub4716.pdf (last visited October 23, 2017).
[17] *See id.*
[18] USTR NAFTA Summary at p. 8.
[19] *See* Canada Open to Digital Trade Adds in NAFTA Renegotiation, Bloomberg Law: Privacy and Data Security, by George Lynch, https://www.bna.com/canada-open-digital-n57982086693/ (last accessed on October 22, 2017); Trans-Pacific Partnership Agreement, retrieved from https://ustr.gov/sites/default/files/TPP-Final-Text-Electronic-Commerce.pdf/ (last accessed on October 22, 2017).

of data found in the TPP applies solely when a state has "legitimate" public policy reasons (e.g., national security).

The USTR may propose narrowing the scope of this restriction considering that "legitimate public policy" may be interpreted broadly. Notwithstanding, representatives of the USTR have indicated that the TPP may be a starting point in determining how to define digital trade and IP-related rights. Ultimately, the objective of TPP is to prevent data localization requirements that undermine cross-border digital trade and data flow, and for that reason may be a helpful starting point for NAFTA renegotiation discussions on the relevant issues.

VI. INCOME TAX CHALLENGES AFFECTING DIGITAL TRADE

Permanent Establishment

In negotiations to include a digital trade chapter in NAFTA, Member States should consider the current income tax provisions in their respective jurisdictions that may inadvertently hinder digital trade and data flow. And though in the United States, Congress has authority over financial and budgetary matters, through the enumerated power to lay and collect taxes, duties, imposts and excises, those involved in the NAFTA renegotiations should consider where local laws concerning income tax in the NAFTA Members States have not addressed digital services and approach the negotiations from a perspective of not only providing sufficient protection to IP rights and removing trade barriers but also considering possible conditional benefits that would be available provided that certain income tax laws are in place with respect to digital goods and services.

For the most part, NAFTA is silent regarding tax treatment of digital transactions. Because of this absence, an enterprise generally must rely on income tax treaties, and federal, state, and local tax rules in order to examine the tax implications of their digital transactions. In many cases, that guidance is lacking.

Under the current Income Tax Treaties between the U.S., Mexico, and Canada, a member country may impose tax on income attributable to an enterprise having a permanent establishment ("PE") in that country.[20] Generally, a PE is a fixed place of business where an enterprise is wholly or partly conducted. It does not include facilities used for storage, collecting information, or conducting auxiliary activity.

For U.S. tax purposes, it is vague whether or not a server alone results in a PE. However, Canada has issued guidance determining that there are circumstances under which a data center owned and operated by a Canadian affiliate of a U.S. group will not constitute a PE of the U.S. parent or another group member company.[21] Nevertheless, each country's tax perspective on maintaining a

[20] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Mex.., art. 5, Dec. 28, 1993; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Can., art. V, Aug. 16, 1984.
[21] Tax Interpretations. 2012 Ruling 2012-0432141R3. https://taxinterpretations.com/cra/severed-letters/2012-0432141r3 (last visited October 23, 2017).

server in its respective country does not provide clear guidance in resolving issues of PE with respect to cross-border digital transactions.

Because each country's tax perspective relating to digital trade is inconsistent, a review of the Organization for Economic Co-Operation and Development ("OECD") report on e-commerce trade may offer helpful insights. The OECD has reviewed this matter extensively and has published its findings which are summarized below.

OECD's Recommended Tax Treatment of Servers

The OECD report introduces amendments to the permanent establishment ("PE") definition and withholding taxes on digital transactions. Generally, the OECD states that a place where computer equipment, such as a server, is located may in certain circumstances constitute a PE, if the functions performed at that place go beyond what is preparatory or auxiliary. Further, PE would be established only if the enterprise engaged in certain "fully dematerialized digital activities" and because of its activities it maintained a "significant digital presence" in the economy of that country. "Fully dematerialized digital" services include:

- The core business of the enterprise relies completely or in a considerable part on digital goods or digital services;

- No physical elements or activities are involved in the value chain other than the external use, or maintenance of servers and websites or other IT tools and the collection, processing, and commercialization of location-relevant data; or

- Contracts are concluded remotely, exclusively via the Internet or by telephone.[22]

A "significant digital presence" would exist if "a significant number of contracts for the provision of fully dematerialized digital goods or services are remotely signed between the enterprise and a customer that is resident for tax purposes in the country."[23]

The report further suggests the inclusion of a virtual PE by adding the following:

- A virtual fixed place of business PE, which would create a PE when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website;

- A virtual agency PE, which would seek to extend the existing dependent agent PE concept to circumstances in which contracts are habitually concluded on behalf of an enterprise with persons located in the jurisdiction through technological means, rather than through a person; and

[22] OECD 2014 Public Discussion Draft. "BEPS Action 1: Address the Tax Challenges of the Digital Economy." at p. 65. https://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf
[23] *Id*.

- An on-site business presence PE, which would look at the economic presence of an enterprise within a jurisdiction in circumstances in which the foreign enterprise provides on-site services or other business interface at the customer's location.

What constitutes a taxable presence with respect to taxes on income is a critical factor for how a multinational enterprise may operate in a particular jurisdiction. If Member States were provided additional guidance on the taxation of digital trade, multinational enterprises and other investors would better understand the income tax implications of digital goods and services, and protections and rules under NAFTA. NAFTA would complement income tax provisions, allowing enterprises to structure their operations in a way that not only minimized income tax liabilities but also eliminated export duties on digital trade and afforded protections for IP rights.

VII. SUGGESTED CHANGES TO NAFTA

IP Box and Digital Trade

There are two relevant parts to the issue concerning an IP box – the income tax and the effect of an IP box on digital trade. With respect to the income tax aspect, in the U.S. the authority and jurisdiction to legislate on matters concerning the income tax rests solely with the Congress. However, as mentioned above, it may be productive for NAFTA negotiators to consider what benefits from an income tax perspective would be helpful to promote the removal of trade barriers and condition certain NAFTA benefits for digital trade on the existence of certain income tax provisions in a NAFTA Member State.

For example, the creation of a patent box may be one of those incentives. A patent box, known as an "IP box," is a preferential tax system that if elected reduces the corporate income tax rate on income derived from qualifying IP assets.[24] Unlike the Research and Development Credit in the U.S. which encourages the development of IP, the IP box promotes the sale and marketing of existing IP assets.[25] This regime has been seen as a preferential tax system that increases local innovation, reduces IP migration, and retains high-value jobs and economic activity.[26]

Certain duty-free transfers of digital goods and services or other additional NAFTA benefits should be conditioned on the existence of certain income tax provisions such as how cloud services or digital advertising will be treated from an income tax perspective or the existence of a patent box regime. The mechanics of a patent box regime would be similar to that of those in effect in other jurisdictions (i.e., UK, Netherlands, etc.). However, by introducing conditional NAFTA benefits based on the existence of a patent box regime, additional incentives would be created for NAFTA negotiators, legislatures over income tax matters, and interested enterprises to focus on

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[24] Cherie L. Jones, Adam A. Rogers, and Damian J. Smyth, *Should the United States Enact a Patent Box?*, The Tax Adviser, p. 1., (2016), https://www.thetaxadviser.com/issues/2016/nov/should-us-enact-patent-box.html (last accessed on October 22, 2017).

[25] American Action Forum, *Patent Boxes, Technological Innvoation & Implications for Corporate Tax Reform,* (2016), https://www.americanactionforum.org/research/patent-boxes-technological-innovation-implications-for-corporate-tax-reform/ (last accessed on October 23, 2017).

[26] Jones, *supra* note 23, at 1.

implementing measures that strengthen the trading bloc of the NAFTA Member while lowering barriers to investment and trade related to income tax and tariffs.

By way of illustration on an IP box, in the U.K., a domestic company or a foreign company with a taxable UK branch that holds an interest in qualifying IP rights (primarily UK and many European patents) or an exclusive license over such rights (perhaps from another group company), can qualify for preferential rates (e.g., 10% instead of 20% corporate tax rate). The patent box regime in the UK even allows 100% of sales income from a minor patented product to qualify under the regime. For instance, if the patents relate to the internal processes used to produce products or underpin the services provided, then these processes still qualify for the patent box regime.

To qualify for the regime, a company must meet three following criteria:

1. Hold a qualifying IP right or an exclusive license over a qualifying IP right;

2. Make a significant contribution to the development of the qualifying patent or any product incorporating the patented invention (this condition can be met either by the patent box claimant company or a member of the same corporate group); and

3. Perform significant management activity to develop or exploit the patented innovation or product using it, even if your company did not develop the original patent or patent-supported product.

Furthermore, only patents granted by the UK Intellectual Property Office or certain European Patent Office qualify. As well as legal owners, the regime will cover exclusive license holders (for example, companies holding an exclusive right to exploit patents in a single territory or field of application) and companies entitled to exploit patents through cost-sharing arrangements or acting in partnership. Generally, income from the sale of products with at least one integral patented component qualify, including license fees/royalties for granting rights over qualifying patents; certain income derived from valuable patents used in processes that underpin non-patented products/services/consultancy; proceeds of realization of a qualifying patent or exclusive license; and income from infringements. Essentially, the UK Patent Box regime reduces the effective tax rate and cash tax payable.

Similarly, NAFTA's incentives for income tax benefits such as through patent box regimes would ensure preferential rates apply to patent-related income. However, the practical implications of such a regime would require NAFTA negotiators to collaborate with legislators focused on international income tax matters to determine what additional benefits may be granted with respect to certain tariffs and what would be a sufficient measure on income tax laws or regulations to qualify for these conditional NAFTA benefits. The policy would encourage IP to remain within NAFTA's Member States and potentially increase investment and strengthen economies of the North American region.

Other Suggested Changes to NAFTA

Separate from income tax matters, there are many other important proposed revisions that would be beneficial. As suggested by the Internet Association, a trade association that exclusively represents leading global internet companies on matters of public policy, there are particular provisions that would greatly enhance the possibility for NAFTA Member States to build on their leadership in the digital services industry. For example, some of the NAFTA modernizations that the Internet Association proposes include:

With respect to data flows and digital services, NAFTA should add an e-commerce chapter with provisions designed to maintain an open internet and prohibit governments from requiring that data be stored or processed locally. Referred to as data localization, requirements that force U.S. companies to manage, store, or otherwise process data locally or other policies that link market access or commercial benefits to investment or use of local infrastructure hurt U.S. businesses and consumers and threaten the open transnational nature of the internet.[27] NAFTA provisions that prohibit data localization requirements across Member States would benefit the digital services industry and create an even stronger trading bloc.

NAFTA should prohibit customs duties on digital transmissions. Some countries have threatened to apply customs duties on digital products. World Trade Organization members have only agreed to a temporary moratorium on imposing such duties. NAFTA should ensure that governments cannot add extra charges on the flow of music, video, software, e-books, and games as they are sold across borders. This will continue to benefit the creators, artists, and entrepreneurs who depend on online sales to get ahead.[28]

With respect to intellectual property, NAFTA should be updated to ensure IP rules work for the digital environment and enable NAFTA Member State digital exports. The Internet Association's perspective is that a strict regime of strong copyright protection and enforcement – without limitations and exceptions like the 'fair use' of copyrighted material – would create significant hindrances to the internet economy and innovation leadership.[29]

Web search, machine learning, computational analysis, text/data mining, and cloud-based technologies all involve making copies of copyrighted content without the explicit consent of the copyright holder. These types of innovative activities are possible under copyright law because of robust limitations and exceptions. Accordingly, NAFTA should be updated to require governments to adopt a strong set of copyright limitations and exceptions, such as the United States system of fair use, to enable these kinds of innovative uses of copyrighted material. Such rules are missing in Mexico, and would set a high standard within the NAFTA framework for other

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[27] Internet Association. "Modernizing NAFTA For Today's Economy." https://cdn1.internetassociation.org/wp-content/uploads/2017/06/InternetAssociation_Modernizing-NAFTA-White-Paper.pdf (last visited October 22, 2017).

[28] *Id*.

[29] *Id*.

countries that threaten to discriminate against NAFTA Member State services through unbalanced copyright regimes.[30]

VIII. CONCLUSION

The United States, Mexico, and Canada have an opportunity to promote a twenty-first century economy that drives innovation and empowerment across North America. A renegotiation of NAFTA to include the considerations and provisions discussed should benefit not only multinational enterprises but also consumers and across the North American region by enlarging markets for products and services among the Member States.

As discussed, income tax benefits intended to encourage trade and investment are a critical component of the considerations a multinational enterprise analyzes to determine investment strategy, and any benefit to be derived is significantly hindered by the absence of rules among the NAFTA Member States that encourage and protect relevant rights for digital free trade. A company may choose to structure its cross-border operations in a way to protect its data and IP rights at the cost of foregoing a potentially more beneficial structure from an income tax perspective.

NAFTA should not only include an e-commerce chapter to protect IP rights of multinational enterprises but also seek to complement the existing income tax benefits under the relevant income tax treaties by removing barriers that hinder the trade of digital services. And the improvements to the NAFTA provisions with respect to digital trade could act as an impetus for tax authorities and legislators to provide much-needed guidance with respect to taxation on income from digital goods and services. In that manner, a multinational enterprise will be in a better position to structure operations in ways that make economic and functional sense by eliminating customs duties on digital trade without undue risk to a company's IP while at the same time allowing the company to benefit from local tax rules within the respective NAFTA Member States and provisions of the relevant income tax treaties that potentially lower the income tax expense and encourage trade and investment among the Member States.

When Company A with its Mexican and Canadian subsidiaries determines how to assign risks and functions to a particular entity in the corporate group, the balance it seeks between the income tax consequences and the operational considerations of its business should supported and protected by appropriate IP laws under NAFTA and relevant income tax rules that foster an environment to promote investment and trade.

[30] *Id*.