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THE UNIQUE FEATURES OF THE PROPOSED UNITED STATES-CANADA TAX TREATY

H. DAVID ROSENBLOOM*

My topic is the unique features of the proposed income tax treaty between Canada and the United States. As there are so many unique features to the treaty, the topic necessarily leads into an overview of the entire treaty.

Preliminarily, however, I wish to make clear the perspective which I brought to the treaty negotiations. I believe very strongly in the need for, and the possibility of, excellent relations between the United States and Canada. We have many problems and many disputes. These cannot be addressed in a mutually satisfactory manner without a shared spirit of conciliation and compromise. Both sides have forces within their boundaries which would pull these two great countries apart, and there is no shortage of excuses for a failure to reach agreement. As a representative of the United States government, however, I believed it was my mission to work in the opposite direction: to seek to bridge gaps and find common ground. Fortunately, Alan Short, who represented Canada in the negotiations, is of a similar mind.

In order to understand and appreciate this treaty it is necessary to understand a little bit about how the United States views tax treaties in general. Broadly speaking, there are five goals that we try to achieve in these treaties.

First, and simplest, we try to avoid double taxation. In the abstract, we seek rules that will bridge conceptual gaps in the tax systems of two countries, in order to prevent the unfairness and distortions of double taxation.

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Second, we try to provide rules to prevent the wrongful evasion of tax in both countries. This is principally accomplished by provisions calling for an exchange of tax information.

Third, we provide for the resolution of concrete international tax disputes through a mechanism known as the "competent authority." Each treaty to which we agree contains a dispute resolution procedure.

Fourth, the United States uses tax treaties as a means of reducing what it considers to be excessive taxation encountered by its businesses and investors abroad.

Fifth, the United States has at various times used treaties explicitly as a means of furthering its non-tax economic policies and foreign relations with other countries.

These five purposes are present in varying mixes in the various treaties. In the case of the negotiations with Canada, it is fair to say that all five elements played a substantial role.

The implementation of these five broad goals is reflected in the Model Income Tax Convention which the United States first published in 1976. The latest draft model was released in June 1981, and it is the third in the series. All of these models are based on the model income tax convention published first in draft form in 1963 and then, revised, in 1977 by the Organization for Economic Cooperation and Development (OECD). The OECD model is something of an international Bible in this field, and the United States model does not diverge much from it; in fact, each of the three versions of the U.S. model has drawn the United States closer to the OECD format and OECD concepts.

The proposed treaty with Canada was negotiated against a very important background of tax relations between the two countries. A 1942 income tax treaty is still in effect. It was amended in 1950, 1956 and 1966, but these amendments were relatively minor; the basic structure developed in 1942 lives on, and, in fact, has withstood the test of time amazingly well. The treaty with Canada is the second oldest United States tax treaty currently in effect.

There is also a 1961 estate tax treaty in effect which is, for all practical purposes, unilateral in nature. Canada has abolished its estate tax, and the treaty is maintained by the United States solely to permit informaton exchange. The proposed new income tax treaty will satisfy this objective in the estate tax area, and it therefore terminates not only the 1942 income tax treaty but the 1961 estate tax treaty as well.

In addition to the influences of United States tax treaty policy and the existing tax relationships, negotiations toward a new treaty were of course heavily influenced by current Canadian tax treaty policy. A significant expression of that policy that was regularly taken into account was the Cana-

dian negotiations toward a new income tax treaty with the United Kingdom. Such a treaty was in fact achieved in 1978, and a protocol to it followed two years later.

Canada is a member of the OECD, and like the United States, Canada participated in the discussions that eventually led to publication of the OECD model. It is significant that in the OECD deliberations Canada announced publicly that it would be prepared to accept a rate of ten percent on royalties being paid from Canada to foreigners investing in Canada. The figure is five percentage points lower than the rate in the current treaty, and, insofar as the United States is concerned, represents a large sum of tax dollars. So Canada is publicly on record as prepared to reduce tax rates on the outflow of this form of investment proceeds.

The proposed new treaty was signed in September of 1980 after nearly a decade of negotiation. A technical explanation was issued by the United States Treasury Department in January 1981, and amended in September 1981, principally with regard to the foreign tax credit.

One way to approach the treaty is through the principal issue it was intended to addresss. On the United States side, five principle reasons prompted the United States to enter into negotiations with Canada to formulate a new income tax treaty. Broadly speaking, all these factors can be categorized under the heading of reducing Canadian taxes on United States investment in Canada.

The first issue raised in the negotiations involved the Canadian imputation system. Both Canadian and American law has changed in important ways since 1942, and even since 1966 when the treaty was last amended. One of the most important changes was the advent in Canada, in the early 1970's, of a system under which corporate taxes are in effect collected at the corporate level and allowed as a credit against liability at the shareholder level. This system is not available to non-residents of Canada. The imputation system is a major tax treaty issue for the United States virtually throughout the world; however, because of the magnitude of American investment in Canada it is especially significant here.

Second, the existing treaty allows a fifteen percent withholding tax on royalties, interest, and on other unearned income flowing out of Canada. This rate is higher than the United States likes and, as previously mentioned, higher than current Canadian policy in at least one major aspect.

The third issue relates to the non-discrimination rules which prohibit Canada from discriminating against Americans investing in Canada. In the current treaty the scope of these rules is extremely limited. They apply only to "citizens," which probably means individuals. There is no protection in the current treaty for Canadian corporations owned by Americans or for American corporations investing directly in Canada.

The fourth issue of concern to the United States is the Canadian "deemed disposition" rules. The 1942 treaty allows for the disposition of capital assets without tax in the source state, but Canada has a number of income realization rules which differ from comparable U.S. rules and it takes the position that the current treaty does not present their application. For example, if a taxpayer should die or relinquish Canadian residency there is a deemed disposition and immediate taxation in Canada, without treaty limitation. In the United States, these are not times when there is a tax due; if Canada insists on taxing at these times there is an obvious potential for a mismatch of taxation and hence double taxation.

The fifth issue concerns the foreign tax credit. The Internal Revenue Service takes the position that the existing treaty provides no guarantee of a foreign tax credit. I do not necessarily share this view, which leaves taxpayers with only domestic law to rely upon and no foreign tax credit protection from the treaty as such. The matter is too important to leave unclarified. Moreover, the current treaty clearly does not contain rules allowing for a "reserving" of income so that the foreign tax credit rules can operate as they should.

In sum, the United States goals in the treaty negotiations were: (1) to reduce Canadian taxation of United States investment in Canada; (2) to clarify certain tax rules; (3) to rectify mismatching due to the differing recognition of income rules which exist in light of tax policy developments in both countries; and (4) to generally modernize the 1942 treaty.

When negotiations began, many years before I went to the Treasury in 1977, the United States and Canada did not have a model treaty to serve as an outline; the OECD materials served as an important guide and negotiation tool. However, there were so many extraordinary factors at play in the negotiation of this treaty that at virtually every stage the OECD provisions required special modification. A close study of the proposed treaty will reveal the alteration and fine-tuning of OECD model provisions in light of these special considerations.

The first special consideration was the number of people and sums of money affected by every single issue in the treaty. All the commercial data are just phenomenal. In fact, the citizens of no other two countries are affected to such a degree by a tax treaty. For this reason it is not possible to put any single issue in this treaty aside on the theory that it is only a minor provision affecting few people. In contrast, at least some aspects of other important United States treaties, for example, the treaty with the United Kingdom, can be handled in relatively boiler plate fashion. Such treaties tend to borrow provisions from the OECD model, but in the case of the United States and Canada that could not be done without very careful consideration of the potential impact.

For example, there is a very large body of United States citizens residing and doing a wide variety of things, in Canada. The United States taxes on both a citizenship basis and a residence basis while Canada taxes on a residence basis. Under normal treaty rules there is no provision to specify which of these two bases of taxation should take precedence, and this may lead to double taxation. The OECD model does not address the problem. In the case of Canada and the United States, not only was it necessary to work this situation out, but it was necessary to provide very detailed rules because of the differing tax situations of the American citizens involved.

Take another example. There are so many people crossing the border, earning income on one side and residing on the other, that a fair amount of attention was required with respect to a problem that does not arise anywhere else in the world in this kind of magnitude. Similarly, social security taxes, because of the number of people crossing the border, become an important issue in the treaty negotiations. The treaty permits Canadian residents to be excluded from the United States social security system, thereby resolving a large amount of potential litigation. This provision principally affects people such as truck drivers and athletes.

Finally, the number and variety of affected taxpayers placing unusual pressure upon the treaty provision relating to the United States taxpayer is present in abundance in this relationship; therefore, the solutions had to be very complex. Thus, the foreign tax credit provisions of the treaty are the geographical and cultural ties that exist between Canada and the United States. Where else in the world would one have to address shipping in the Great Lakes, or along the St. Lawrence River where a single journey may cross the border five or six times? Where else would one have to deal with international transportation by motor vehicle and railway? If we ever get to the point of negotiating a treaty with Mexico these issues will come up again, but in the case of Canada they represented not only live issues but major ones and ones that the OECD model and other tax treaties do not touch.

In the area of cultural ties, many people on each side of the border have been educated in the other country. The treaty addresses this situation by providing special rules which contemplate changes of residence because, as Alan Short reliably implied to me, residents of Canada currently own Florida. There are always large numbers of people changing residence, at least coming down from the snowy north to the sunnier south. Where else would one find a tax treaty that refers to "regularly scheduled games in both leagues?" It will be interesting to see how the Internal Revenue Service deals with that provision.

A fourth special consideration was the substantial tax history that exists between these countries. This required elaborate traditional rules so that

changes in the prevailing rules would operate fairly, as well as a number of grandfather provisions.

Finally, both countries are acutely aware of developments on the other side of the border, probably more so than in the case of other treaty situations to which the United States is a party. The Canadians, for example, are very concerned that the United States will change its tax system to tax undistributed earnings of foreign subsidiaries of United States corporations. The United States, on the other hand, is very concerned with the direction of the Canadian energy program and with the enactment by Canada of non-deductible excise taxes. Such non-deductible taxes are deductible in the United States and have the effect of raising substantially the effective Canadian rate on American investment in Canada at the expense of the United States Treasury; moreover they create many technical problems in the United States.

The Senate Foreign Relations Committee held hearings on the Canadian tax treaty, among others, in September 1981, and further consideration was deferred while certain issues are resolved by way of a protocol. It is hoped by many people that a new protocol can be negotiated soon, and that hearings can go forward in the United States leading to Senate approval. In conclusion, I will review a number of the controversial treaty provisions which have thus far been an impediment to Senate approval.

In 1980, Congress enacted a law allowing for the taxation of gains from the disposition of interests in United States real property, and the treaty, with dissimilar provisions, came up for consideration less than a year after that law went into effect. Reaction of the tax-writing committees was that they did not want their new law tinkered with, and I believe that Alan Short and his counterpart, my successor, will have the burden of figuring out how to solve this problem.

Second, border broadcasting and foreign conventions have been terribly controversial issues throughout the negotiations. Canadian law denies deductions for advertisements placed on United States television stations. It is an element of Canadian economic policy which no tax policy expert would, in my opinion, defend as a fair or particularly effective response to the problem of protecting the integrity of Canadian culture. The United States has recently decided, in reaction, that it would take reciprocal tack with respect to advertising in Canada. The issue was not dealt with in the treaty; however, it has become linked in the Senate with the question of denying deductions to attendees of foreign conventions, which is the general United States statutory rule. In 1980, the United States changed its statutory law to allow deductions for Canadian conventions. In addition, however, a reciprocal provision allowing deductions claimed by residents of

one country for conventions held in the other was included in the treaty. Although the foreign convention issue has, for the moment, been solved outside the treaty context, there is still a great deal of bitterness on both sides of the border with respect to border broadcasting.

A third important issue is the controversy over mineral royalties. The proposed treaty removes the fifteen percent cap on taxation of such royalties at their source, permitting each side to tax them under domestic statutory law. The Canadian tax is twenty-five percent. People affected by the change are disturbed even though the change is very much in accordance with OECD principles and even though the present Canadian rate is well within the limits on the foreign tax credit for such income in the United States.

There are several other issues of lesser importance. For example, the treaty raises the rate on royalties for video tapes from zero to ten percent. There was some testimony in the Senate in opposition to that change. There was also some discussion with respect to the change with non-discrimination provisions. The existing treaty has, as I have mentioned, little coverage of this subject and the new treaty has substantially more coverage, but not as much as the United States prefers to have in its tax treaties. There has been a good deal of rumbling and grumbling to the effect that the United States should not sign a modern treaty that concedes as much as this treaty does to a country that wishes to discriminate against investment from abroad. However, Canada has agreed in this treaty to a non-discrimination clause that is probably stronger than any comparable provisions in any of its other tax treaties. Given the limited scope of the existing treaty, and the virtual impossibility of terminating that treaty, the choice is not between what is in the proposed treaty and some ideal, but between what is in the proposed treaty and what is in the existing treaty.

Finally, the tax implications of the Canadian energy program bear importantly on the chances of the proposed treaty in the Senate. A number of United States oil companies are concerned about the Canadian program; even without considering the direct tax impact. The resulting controversy will adversely affect the ability to pass the treaty through the Senate approval process. A more technical issue is the credibility of Canadian corporate taxes when imposed on a base which does not allow a deduction for a substantial item — an excise tax at rates ranging upward from sixteen percent paid to the federal government in Canada. The issue is whether the corporate tax on the mineral sector in Canada is a creditable tax under United States statutory law. Normally in the United States for a foreign tax to be creditable it must be imposed on net income in the United States sense — that is, taking account of the significant expenses incurred in

earning the income. Canada currently does not allow deductions for a number of items and the added effect of the new unpredictable excise tax is bound to raise serious problems.

I am obviously very much committed to this treaty, and believe that investors and tax administrators on both sides have a need for a new agreement. There are people who are suffering under the existing treaty because it simply does not address many problems. The proposed new treaty may not solve these problems but it addresses many of them. The treaty process is complex and it is easy for one or two groups, with some lobbying and some plausible complaints about particular items, to prevent ratification. I am hopeful, however, that the importance of this treaty will win the day, and that we will soon see it ratified and in place.

THE PROPOSED UNITED STATES-CANADIAN TAX TREATY: THE CANADIAN PERSPECTIVE

R. ALAN SHORT*

I have a personal as well as a professional interest in seeing the ratification of the proposed United States-Canadian tax treaty. I have devoted eight years to its development and that is a very long gestation period. It is about time that we finally gave birth to something. David Rosenbloom's presentation has covered most of the technical aspects of this unique treaty, so my comments will primarily deal with the Canadian view of this treaty and of tax treaties in general.

It is rather interesting that the proposed United States-Canadian Tax Treaty is being discussed in terms of Canadian regulation and restriction of American investment. This nomenclature implies a negative attitude toward American investment, but the very function of a tax treaty is to facilitate trade and investment.

Tax treaties are very important in facilitating trade and investment. Trade provisions relating to 'permanent establishment' and to 'the taxation of technical and professional services' are obviously important for international trade. In a sense these treaty provisions require the host country to give up some tax, and the residence country to provide relief from double taxation. These provisions bear even more directly on the investment side. It is widely known that tax treaty provisions which reduce withholding tax rates on dividends, interest and royalties facilitate investment. One cannot underestimate a number of other treaty provisions which aid investment. Some of the administrative provisions, such as the mutual agreement procedure, provide a significant measure of protection for international investment.

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Tax treaties, in the context of time, are a relatively recent development. The United Kingdom, around the beginning of this century, was the first country to understand, recognize and indeed actively pursue a very active treaty program. This can be attributed to its position as a financial and commercial center of the world and to a very expanded empire. Canada, and indeed most other countries, awoke more slowly to the importance of treaties, but now virtually all the developed countries recognize their importance. In addition, there is a growing awareness in the Third World that such treaties are a precondition for attracting private foreign investment and the administrative and technical skills which so often accompany such investment activity.

Earlier treaties were generally of an *ad hoc* nature and they did not form any recognizable pattern. These treaties were difficult, and they addressed specific concerns, but gradually the trend has been to standardize tax treaties when possible. This standardization has been made possible through the efforts of the Committee on Fiscal Affairs of the OECD which, after a number of years, published a model tax convention. Even before it was published, work began to update the convention and to expand the scope of the convention. The result of this effort was the publication in 1977 of a revised model convention, which provides for virtually all tax treaty negotiations. Not all countries accept the OECD prescription, but the OECD model has resulted in a very marked improvement towards standardization of tax treaties. Ordinarily, where there is variation from the OECD model, the variations are carefully constructed and explicitly agreed to by the parties. In this manner, international investment is well served.

Canada has largely adhered to the OECD convention although we regard that treaty as having been formulated under the influence of countries which were for the most part capital exporting countries. Canada, of course, is a large capital exporting country, but we are also a large capital importing country. We must be mindful of the extent to which we are in that second category. We attempt, therefore, to create a balance. We are not prepared to eliminate the tax on royalties or interest or to reduce it dramatically, or even to reduce it to 5%. It is very difficult for us to see that the withholding tax rates which we have sustained for a long period of time have been sufficiently high to discourage foreign investment. Indeed, we have, as you learned this morning, foreign investment to the extent that is probably unprecedented, at a time when our tax rates have not been as low as those in the OECD and in the United States. Now the United States and the OECD would like us to remove these tax barriers to investment. It was in that context that we entered into the negotiations with the United States to revise the old tax treaty.

Canada and the United States recognize the need for a modern treaty; one that reflects reality. The existing tax treaty is forty years old which is a remarkable period of time for a treaty to remain in force. This longevity is due to some extent to forebearance, but the time had come when we really faced no choice but to renegotiate the treaty so that it would reflect modern economic reality. The complexity of our tax system, which has grown enormously over the course of forty years and the complexity of the fiscal relationship which we, let me use the word, *enjoy* with the United States has also grown. When we set out to review the old treaty we recognized that we faced three choices: (1) we could continue to live with the existing agreement, outmoded as it is; (2) we could enter into a new agreement in which the interests of both countries are protected; (3) we could end the fiscal relations with the United States. The third choice is something which is really beyond practical political possibility. We have, therefore, reached a compromise. The compromise is not based on basic underlying principles wedded together, because the principles on which each country bases its tax system are so different. We did, however, recognize a need to come to terms on some substantive areas and get a settlement which we could both live with. These negotiations have taken an extended period of time and a good result has been achieved, and I think it has been achieved in a way that the treaty is a compliment to all parties involved.

Currently, a new round of negotiation is beginning. Negotiators on both sides will be meeting next week in Washington to discuss the possibility of a protocol to amend aspects of the treaty which was signed in September 1980. The proposed treaty has been in the public domain for over a year now and has been the subject of very extended commentary and analysis. It is clear that we have benefited from the analysis that has taken place, and out of that process we have seen areas in which there could be improvement. The protocol will most likely not make major change in the principles or the practical solutions that are embodied in the existing agreement; nevertheless, some technical aspects, defects and bloopers have been identified. We, Canada, would benefit by clarifying these technical aspects of the agreement. In addition, the United States delegation has requested a review of some of the treaty provisions. The impetus for these requested changes is new investment legislation in the United States arising with respect to the taxation of foreign investment in real estate (FIRPTA). We are entering into the discussions next week, optimistic that we will be able to dot the "I's" and cross the "T's" which are necessary in order to enable us to proceed with a final agreement.

In Canada, the agreement will require enabling legislation and the legislative agenda in Canada is currently extremely full. There is a very con-

siderable backlog of legislation in which the government is anxious to proceed with arising out of the National Energy Program; the agreements with the producing provinces arising out of the recent budget; and certain other legislation. In my opinion, because of the importance to Canada of this tax treaty, it will be the subject of extended hearings and of fairly comprehensive review in the Canadian Senate and possibly within the House. Once the Senate and House finally agree to necessary legislation, the treaty will have to be dispatched so that it may receive royal assent. Although this process is time consuming, it certainly will be dealt with as rapidly as possible so that the treaty can be implemented.