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THE INCOME TAX CONVENTION BETWEEN CANADA AND THE UNITED STATES: A RETROSPECTIVE VIEW

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At the time of its signing in September 1980, the income tax convention between Canada and the United States[1] was the most complex and sophisticated tax agreement that had ever been negotiated between two countries. This remained the case when the convention entered into force five years later, and it arguably remains so to this day.

When the authors of this paper first met in the fall of 1977 to continue negotiations that had been in process already for several years, the difficulties obstructing a new income tax convention between Canada and the United States seemed, from many points of view, insurmountable. Nasty political disputes raged over the ability of Canadian residents to claim deductions for advertisements placed in US media and for US persons to deduct the costs of conventions and seminars held in Canada. The US Treasury, having recently persuaded the United Kingdom to accord substantial benefits to US holders of stock in UK companies in order to parallel the imputation benefits available to UK individual shareholders, was determined to secure similar benefits from other countries with imputation systems—most notably, Germany and Canada. Complicating the negotiations was Canada's concern with the degree of foreign (that is, US) ownership and control over major sectors of its economy. A basic feature of Canadian tax policy was, and remains, to encourage domestic investment in Canada through such measures as the dividend tax credit and extensive concessions to Canadian-controlled private corporations. This made unacceptable to Canada the broadly based non-discrimination clause that was a priority for US negotiators. This policy concern also governed Canada's reluctance to reduce withholding tax on dividends with respect to direct investment. Finally, an extraordinary number of unusual issues had arisen from the lengthy shared border, the existence of numerous commuters and investors across it, and the remarkable

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1 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended to the protocols signed on June 14, 1983, March 23, 1984, and March 17, 1995 (herein referred to as "the convention").

degree to which Canada and the United States were enmeshed in each other's economic and tax affairs.

The then existing income tax convention between Canada and the United States dated from 1942. It had served well over the years, but was clearly showing signs of stress as a result of new forms of business, new concepts bred of deliberations at the Organisation for Economic Co-operation and Development (OECD), technological developments, and other changes in the prevailing business and tax worlds. Negotiations toward a new convention had begun in the early 1970s and progressed to some extent, but there remained much to negotiate, review, and refine. In this process would figure prominently such considerations as geography, special features of domestic law, history under the old convention, and the interaction of two of the world's most complicated tax systems.

In the end the many problems were either resolved or shunted aside and the new convention was signed and, eventually, ratified. Squarely based on the work of the OECD, that convention also reflected the then existing model conventions used by Canada and the United States, the 1942 Canada–US convention, and recent treaty experience of both Canada and the United States, particularly (in both cases) with the United Kingdom. The result was a document that, in both structure and text, was familiar to the international tax community.

In the spring of 2000, the authors were asked to look back at the convention, to identify its salient themes, and to assess its functioning after 15 years of experience. This paper responds to that request.

This is not the first time we have attempted a survey of the convention. In 1982, before the agreement went into effect and while the first two (of an eventual four) protocols were being negotiated, we participated in a symposium at Boston University on "Canadian Regulation and Restriction of American Investment." Our remarks were transcribed and subsequently published in the *Boston University International Law Journal*.[2]

Our objective then was principally to describe the context in which the convention had been negotiated—to explain the policy motivations of Canada and the United States in coming to the table and striking an agreement that, only a few years earlier, had appeared out of reach. We also reviewed a variety of technical points in the convention and expressed hope for approval in the respective legislatures and early ratification.[3]

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2 H. David Rosenbloom, "The Unique Features of the Proposed United States–Canada Tax Treaty" (1982), 1 *Boston University International Law Journal* 63-70; and R. Alan Short, "The Proposed United States–Canada Tax Treaty: The Canadian Perspective" (1982), 1 *Boston University International Law Journal* 71.

3 Our enthusiasm was not shared by everyone. See, for example, Charles I. Kingson, "The Coherence of International Taxation" (1981), 81 *Columbia Law Review* 1151-1289, at 1261-62:

> In defense of the treaty, it ingeniously solves important problems concerning double and inconsistent taxation of the large number of nationals who work, live, or do business in the

Subsequently, the negotiators spoke on numerous public occasions with regard to the substance of the convention, its technical particularities, and its likely implications for tax planning and the resolution of cross-border tax disputes. Appended to this paper are two examples of outlines that purport to identify the principal features of the convention, as seen by one of its negotiators in the mid-1980s, and the elements making up the circumstances in which the convention was negotiated.

Now our focus is different—less technical, less comprehensive, and informed (to some extent) by experience. The convention had been amended by two protocols by the time it went fully into effect on January 1, 1985. Two additional protocols entered into force in 1995 and 1997. Today, only 8 of the original 31 articles remain exactly as they were at the date of original signature, September 26, 1980. The years (and protocols) added three completely new articles, XXVI A (Assistance in Collection), XXIX A (Limitation on Benefits), and XXIX B (Taxes Imposed by Reason of Death). And the protocols have substantially revised most of the other articles, including all those that have operational importance for most taxpayers.

So what can be said of the original convention, beyond what we have already said, and from today's point of view? There are several general observations we wish to offer.

First, the convention seems to have been, by and large, successful in establishing a mechanism allowing these hugely important trading partners to deal with international double and multiple taxation issues. The rules have changed over the years; the concerns have varied; the tax policies pursued by both Canada and the United States have mutated in various ways. But the structure of the convention has withstood the weight of these changes, bending through interpretation or amendment, and is still recognizable. Particular issues—the meshing of Canadian income tax at death and US estate tax, for example—have required particular treatment, but such new issues and problems have been addressed and successfully incorporated within the convention's overall framework.

Second, the convention appears to have spawned relatively little controversy. There have been only a few cases in which courts have been asked to render an important interpretation, perhaps most notably the *Crown Forest Industries* decision in Canada[4] and the *North West Life Assurance Co.* case in the United States.[5] It is surely too early to conclude that all major issues have been addressed and that there remains no room for controversy, but it is somewhat heartening, at least to us, to note the absence of substantial litigation over the convention's meaning.

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other country; and it may be considered that a weak nondiscrimination clause improves on none. But a treaty cannot ultimately be justified on the basis that—as Oppenheimer said about the atomic bomb—the solution it represents is "technically sweet." [Footnotes omitted.]

4 *The Queen v. Crown Forest Industries*, [1995] 2 SCR 802.

5 *North West Life Assurance Co. v. Comm'r*, 107 TC 363 (1996). See also *Clayton v. United States*, 95-2 USTC ¶ 50,936 (US Ct. Fed. Cl. 1995), aff'd. 86-1 USTC ¶ 50,314 (CA Fed. Civ. 1996), dealing with application of the convention to an employee stock ownership plan.

Third, it is interesting and useful that the technical explanation of the convention, prepared by the US Treasury,[6] was explicitly accepted in principle by Canada,[7] thus expanding considerably the range of the agreement reached in the convention itself. This agreement to join in a written interpretation of a double taxation convention is by no means routine. Although standard practice in the United States includes a technical explanation, chiefly to record the interpretive gloss placed on a treaty by its negotiators and to inform the Senate regarding implications of treaty provisions, there are no other recorded instances in which the United States and a treaty partner have reached agreement in principle that a technical explanation represents an accurate reflection of what has been negotiated.

Looking back on the convention from the vantage point provided by 15 years of experience, we believe the single aspect of the convention most worthy of emphasis is its flexibility. In numerous ways, the convention allows for breathing space—in the discretion afforded to the competent authorities to implement the agreement in the spirit in which it was intended. Whether such implementation has invariably met these expectations is another matter; the opportunities were provided and are still there to allow the deal to work in practice. This is especially important for this deal, because the convention moves beyond technical—or so-called juridical—double taxation, and attempts in various ways to address economic double taxation as well. In that sense the convention aims to be more than a strictly legal, or legalistic, document, and to promote fair and reasonable results in more general terms.

It is also true that this convention had to encompass a number of unique cross-border issues, found in multitude only between Canada and the United States, and to provide practical solutions that would respond to the perceived needs of each country. On most of these matters the model offered by the OECD was of limited use; other countries were not called upon to face the same fact patterns, or did not have the numerous variations found in the tax relationship between Canada and the United States, or did not have to deal with such complex domestic law rules that had to be meshed if double taxation was to be avoided. It seems to us that a second major feature of the convention, in addition to the flexibility that it allows, was the tackling of many issues served up only between these two countries.

Finally, the convention contains numerous "small-bore" provisions—rules and amendments to rules intended to increase the efficiency and functioning of the convention for the many taxpayers destined to live with it as the major mechanism for addressing international tax issues. These provisions were not necessarily unique to the Canada–US relationship but might, in fact, be considered by any treaty partners wishing to improve upon the various models available to treaty negotiators. In some

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[6] United States, Treasury Department, Technical Explanation of the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, April 26, 1984 (herein referred to as "the technical explanation").

[7] See *North West Life Assurance Co.*, supra footnote 5, at 385.

respects the innovations of the convention as originally negotiated proved unsuccessful, or in need of further refinement by protocol, and it is probably also true that some of them could only be made to work in an agreement between these two particular countries. Nevertheless, the convention did offer several improvements for general consumption that seem to have stood the test of time.

These three themes—flexibility, attention to unique Canada–US issues, and substantive innovations of the concepts underlying double taxation agreements—are developed in the pages that follow.

A FLEXIBLE AGREEMENT

Negotiators of the convention were acutely aware that there was little chance of recognizing all the income tax interrelationships between Canada and the United States as they existed at the time of negotiations, much less as they might develop over the expected lengthy life of the convention. The response to this problem was to delegate substantial leeway to the competent authorities, with a charge to avoid double taxation and make the convention function as intended. The principal delegation is found, of course, in article XXVI, dealing with the mutual agreement procedure. But the same spirit animates article IX (Related Persons), as well as article XXI (Exempt Organizations), article XIII (Gains), and many other provisions. In each case the negotiators' hope was that the persons responsible for administering the convention would interpret it in the general sense in which it was negotiated—namely, with a view to avoiding double taxation and providing, as far as possible, a mutually cooperative environment for the avoidance of abuse (fiscal evasion) in both countries and for the resolution of cross-border tax disputes.

Thus, article XXVI contains provisions allowing for "the elimination of double taxation in cases not provided for in the Convention" and for "increases in any dollar amounts referred to in the Convention to reflect monetary or economic developments." Both provisions in paragraph 3 were fairly unusual and evidence the flexibility that the negotiators sought. The provisions were not broad enough to dispense with the need for a protocol-added subparagraph, providing relief from double taxation in situations involving conflict between the US estate tax and Canadian income tax applicable to a distribution of property by a trust. Still, there would doubtless have been more cases requiring supplemental protocols, and the convention would have been less flexible, were it not for article XXVI.

A more specific example of flexibility appeared in paragraph 8 of article XIII (Gains):

> Where a resident of a Contracting State alienates property in the course of a corporate organization, reorganization, amalgamation, division or similar transaction and profit, gain or income with respect to such alienation is not recognized for the purpose of taxation in that State, if requested to do so by the person who acquires the property, the competent authority of the other Contracting State may agree, in order to avoid double taxation and subject to terms and conditions satisfactory to such competent authority, to defer the recognition of the profit, gain or income with respect to such property

for the purpose of taxation in that other State until such time and in such manner as may be stipulated in the agreement.

Both Canada and the United States have intricate, detailed domestic law provisions relating to the tax consequences of changes in corporate structure. Reconciliation of these provisions by specific rules would not have been practical. Nevertheless, the negotiators recognized that unless some provision dealing with this subject was inserted in the convention, there was a realistic chance of double taxation arising from mismatches in timing and other aspects of the domestic law rules. Paragraph 8 allows the competent authority of the source country to tailor an agreement to the circumstances presented, in order to further the convention's principal aim of avoiding double taxation. It is not clear to us how many agreements have been sought or reached under this provision, but a rule of this sort has been suggested by US multinational companies to US treaty negotiators for consideration in their dealings with the United Kingdom and other developed-country treaty partners. And in the third protocol to the convention, the rule was extended to transactions involving other entities such as partnerships by the addition of the words "or other" after the word "corporate."

One area where implementation by tax administrations was perhaps more grudging than the negotiators had foreseen was with regard to exempt organizations. Paragraph 2 of the September 26, 1980 letters of understanding appended to the convention expressed the expectation that the competent authorities would work together to facilitate recognition of each other's exempt entities, in order to circumvent the potentially burdensome requirements for an organization of one country to achieve exemption in the other. The notion was that neither country would insist on fulfillment of all the technicalities of its law but would, instead, defer to the maximum extent possible to procedures and decisions of the other country that had the same policy thrust. It is not clear how far this process has advanced in the years since the convention entered into force.

CANADA–US FEATURES

The convention is filled with provisions that address circumstances unique, or virtually unique, to the relationship between these two countries. Many other treaty partners, after all, do not have to deal with issues arising from international transportation by motor vehicle or railway, as paragraph 4 of article XIII (Transportation) does. Few must consider the international tax consequences of a vessel crossing and recrossing a river, as found in paragraph 3 of that same article. And even fewer countries are called upon to ask whether a tax convention's provisions relating to artistes and athletes should apply to "an employment with a team which participates in a league with regularly scheduled games" in both countries, as paragraph 3 of article XVI (Artistes and Athletes) does.

Perhaps the most pressing of the Canada–US tax issues affecting individuals at the time of negotiation arose from the existence of a large number of individual taxpayers who reside in one of the two countries but receive income from sources in

the other country. These individuals earn substantial sums from rendering services, from pensions and social security payments, and from investments in the country where they do not reside. The 1942 convention did not adequately address the concerns of these taxpayers, particularly US citizens residing in Canada, with regard to international double taxation. Numerous cases had come to the attention of authorities in both Canada and the United States.

The convention spoke to these sorts of issues in many different places. Article XVII, a provision based on the 1942 convention, placed limits on the withholding of taxes in respect of independent personal services. Paragraph 4 of article XXV (Non-Discrimination) limited US taxation of married Canadian residents to the tax that would apply to a joint tax return, even if the US domestic law requirements for filing on that basis were not otherwise met. Paragraph 3 of the same article addressed the issue of allowances for cross-border dependants, in much the same spirit as the joint-return provision. Paragraphs 5 and 6 of article XXI (Exempt Organizations) attempted to expand deductions allowable under the 1942 convention for cross-border charitable contributions, a concept quite unusual and potentially controversial in the United States.

Article XVIII, dealing with pensions and annuities, spoke to the treatment of any taxpayer earning cross-border retirement income. Reflecting the complexity of the domestic law rules on both sides of the border, paragraph 1 stated, extraordinarily, that pensions and annuities arising in one country and paid to a resident of the other could be included in the tax base of the country of residence only in the amount that would be taxed in the country of source if the recipient were a resident of that country. A similar rule appeared in paragraph 6, relating to alimony and similar amounts, including child support. The notion was taken to its logical extreme in paragraph 5, dealing with social security payments (which, at the time, were fully exempt in the United States): it provided for exclusive taxation in the country of source (a provision that has since been amended by three of the four protocols).

These rules, giving primacy to the source country, reflected the notion that the rules of the country under whose laws the plan or arrangement had been established should govern, irrespective of the residence of the taxpayer at the time of payment. People are mobile; many have earned income in one country and qualified for retirement benefits, but return to the other side of the border by the time a payout is made. To these provisions should be added paragraph 5 of article XXIX (Miscellaneous Rules), dealing with US citizens in Canada who are beneficiaries of a Canadian registered retirement savings plan. The provision authorized deferral of US taxation of the income thus generated, but not distributed, under rules to be established by the US competent authority. Once again, the overriding spirit here was acceptance of the source country's rules in a complex area of potential interest to many taxpayers. The provision could also be viewed as another, very specific, example of the flexibility called for by the convention.

The most important of the convention's provisions dealing with US citizens resident in Canada were doubtless those of paragraphs 4, 5, and 6 of article XXIV

(Elimination of Double Taxation). These provisions, which have since been followed in spirit in many subsequent US treaties, provide a hierarchy of source, residence, and citizenship taxation. When the source country is the United States, it is accorded the first slice of tax, but only to the extent that the convention would permit it to tax an individual who was not a US citizen. The country of residence—Canada—is given the next slice. The United States, which insists in the saving clause of paragraph 2 of article XXIX (Miscellaneous Rules) on its right to tax US citizens unfettered by the convention, goes last (in addition to first), agreeing to credit the Canadian tax calculated after Canada gives credit for the US source tax.

A complicating factor is Canada's allowance of a deduction for the US tax in excess of 15 percent, which gives rise to a circular conundrum: which country is to proceed first? Paragraph 5 of article XXIV makes it clear with respect to dividends, interest, and royalties that as long as Canadian law allows a deduction from income for US tax in excess of 15 percent, the deduction is not reduced by the foreign tax credit that the United States allows for Canadian residence-basis tax. Hence, the deduction equals the pre-credit and thus "tentative" US tax in excess of 15 percent. Canada also allows a credit ("deduction from the Canadian tax," as contrasted with the "deduction in computing income" for the US tax in excess of 15 percent) for the amount of US tax authorized on a source basis, but that credit "need not exceed 15 percent of the gross amount of such items that has been included in computing the income of the citizen for Canadian tax purposes."

Finally, the United States agrees in paragraph 6 to resource the income in question to Canada "to the extent necessary to avoid the double taxation of such income." This provision, perhaps implicit in the paragraphs just described, makes clear beyond cavil that the United States not only will allow a credit for Canadian residence-basis tax (computed with a credit for US source-basis tax of up to 15 percent and a deduction for tentative US tax in excess of 15 percent) net of the US source-basis tax, but that there will be sufficient foreign tax credit limitation to allow the credit to be used.

Taken as a whole, these provisions break the circle of credit and deduction, slot source tax before residence tax and residence tax before citizenship tax, and allow for a generalized resourcing of income to the extent necessary to make room in the US foreign tax credit regime for Canada's—but not a third country's—tax. This was an intricate set of provisions, as the technical explanation amply demonstrates.

GENERAL INNOVATIONS

The convention, as noted, contains a number of provisions that differ from the models used by both countries in its negotiation and that cannot be said merely to respond to unusual aspects (geographical, business, tax) of the Canada–US tax relationship. These provisions, not all of which have survived amendments by the protocols, represented general experiments that, in theory, could be adopted by any tax treaty partners.

Thus, paragraph 4 of article VII (Business Profits) provided—and still provides—that profits should not be attributed to a permanent establishment by reason of "the

mere provision of executive, managerial or administrative facilities or services" for the resident with a permanent establishment in the source country. This rule was in addition to the similar provision, in the same paragraph, calling for no attribution of profits by reason of "the mere purchase of goods or merchandise" for the resident—a much more traditional and widely employed rule. The addition was thought acceptable by two countries wishing generally to limit source-basis taxation of permanent establishments, especially in light of the mobility of personnel crossing the border to do business.

Similarly, paragraph 7 of article VII makes clear that "the business profits attributable to a permanent establishment shall include only those profits derived from the assets or activities of the permanent establishment." This rule was adopted to ensure that the "limited force of attraction" of section 864(c)(3) of the Internal Revenue Code would not apply in the Canada–US context. The statute provides that a nonresident taxpayer with a trade or business in the United States is subject to a tax on all US-source income other than fixed or determinable annual or periodical income and capital gains that are not effectively connected with that trade or business. In other words, other US-source income is deemed to be effectively connected, regardless of its actual nexus with the trade or business. Canada (like many other countries) objected to this provision, and paragraph 7 was intended to foreclose its application in the Canada–US context.

An index of how unpredictable the process of negotiation and drafting may be was the *North West Life Assurance Co.* case, in which the US Internal Revenue Service (IRS) relied on paragraph 7 and its discussion in the technical explanation to defend the application of section 842(b) of the Internal Revenue Code, imputing a minimum amount of investment income to the US branch of a Canadian insurance company. Section 842(b) proceeded on the basis of US industry averages and was therefore, quite obviously, discriminatory. (By definition, a requirement that a foreign company must report income in accordance with average results of domestic companies means that it may be required to report more income than some domestic companies.) However, the court did not rely on or interpret article XXV (Non-Discrimination), but instead grounded its decision for the taxpayer in article VII. The majority and a concurrence found inconsistency with section 842(b) in several paragraphs of that article. Three full opinions (there was a dissent), dealing with paragraphs 2, 1, and 7 of article VII, demonstrate how much more difficult than non-discrimination these issues were. Ultimately, the court reached the correct result—inapplicability of section 842(b) in light of the convention. It might well have cited the provisions of paragraph 7, and the technical explanation language invoked by the IRS, as positive confirmation that the kind of imputation called for by section 842(b) was not consonant with the convention.[8]

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[8] The majority opinion, resting on paragraph 2, tortured the technical explanation discussion of paragraph 7, which clearly stated that only income derived from assets or activities of the permanent establishment, and not those deemed to be so derived, could be taxed by the source country.

Another provision worth citing as a general innovation appears in paragraph 7 of article XIII (Gains):

> Where at any time an individual is treated for the purposes of taxation by a Contracting State as having alienated a property and is taxed in that State by reason thereof and the domestic law of the other Contracting State at such time defers (but does not forgive) taxation, that individual may elect in his annual return of income for the year of such alienation to be liable to tax in the other Contracting State in that year as if he had, immediately before that time, sold and repurchased such property for an amount equal to its fair market value at that time.

This provision, requiring no intervention by the competent authorities, seems usefully aimed at timing mismatches and the economic double taxation they foster. The principal mischief to which the rule is addressed is the deemed realization of income for Canadian tax purposes with respect to certain capital properties when an individual ceases to reside in Canada. In the United States, any gain or loss would be recognized under domestic law only on the disposition of the property.

The convention also contained an extraordinary procedural provision appearing in both article XXVI (Mutual Agreement Procedure) and article IX (Related Persons), under which a time limit of six years was established for giving notice of a cross-border dispute to the country potentially requested to make a correlative adjustment. Under paragraphs 3 and 4 of article IX, the country asked to make a corresponding adjustment with respect to transactions between related persons was relieved of its obligation even to consider doing so unless it was notified by the other country within six years from the end of the taxable year to which the adjustment related. If notification was not given by the initiating country, and if the taxpayer did not have at least six months' notice so that it could give notification itself, the country initiating the adjustment (under the originally negotiated formulation of this provision) would withdraw the adjustment to the extent necessary to avoid double taxation. Paragraph 2 of article XXVI contains a parallel six-year rule for competent authority agreements not involving article IX, notwithstanding any time or other procedural limitations in the domestic law of the two countries. It, however, never contained any commitment by the country initiating an adjustment that it would abandon the adjustment if notification was not given in timely fashion to the other country.

These were tough provisions, which were adopted in light of the very substantial delays then—and still—occurring in US examination practice. Canada did not want its statute to remain potentially open for years, with the possibility of surprise requests for correlative adjustments emanating from south of the border. The provision in article IX, which was especially stringent, has since been watered down, and now states that the country that initiates an adjustment "may provide relief from double taxation where appropriate." The rule relating to giving notice to the taxpayer has also been eliminated.

One further change to the rule provides another example of the difficulties of establishing the negotiators' purpose clearly. Although paragraphs 3 and 4 of article IX

were unusual, they seemed relatively straightforward at the time of negotiation, at least to us. However, tax administrators interpreting the paragraphs lost sight of the intention to require reopening of the statute of limitations only under certain defined circumstances. Instead, they read the six-year rule as absolute, and therefore applicable even if the statute of limitations was open in both countries. A protocol was necessary to dispense with this senseless interpretation and provide that the competent authorities "may agree to consider cases where the corresponding adjustment would not otherwise be barred by any time or procedural limitations in the other State, even if the notification is not made within the six-year period." Plainly, negotiators cannot assume that persons charged with administering a tax treaty will come to their task with a complete understanding of the negotiators' intent.

Another example of an innovative provision not grounded in any unique aspect of the Canada–US relationship is the substitution of the words "person in" for "resident of" in paragraph 1 of article IX, dealing with related persons. The purpose of this unusual wording was to allow for the avoidance of double taxation in cases involving residents of third countries who are taxable in Canada or the United States and who have "arrangements" of the type described in article IX with either a related resident of the other country or a related "person in" that country. The animating idea was that the domestic laws of Canada and the United States might give rise to situations involving double taxation for which there would be no relief under a more orthodox treaty provision.

The technical explanation describes the intention clearly, stating that "the term 'person' encompasses a company resident in a third state with, for example, a permanent establishment in a contracting state." This statement, in turn, dovetails with paragraph 9 of article V (Permanent Establishment), another unusual provision, which states that "for the purposes of the Convention, the provisions of this Article shall be applied in determining whether any person has a permanent establishment in any State." This provision is of more general relevance, however, and would, for example, control in a situation involving sourcing under paragraph 6 of article XI (Interest) or paragraph 6 of article XII (Royalties).[9]

There has been some resistance by tax administrations to the proposition that a person not resident in either Canada or the United States should be entitled to competent authority consideration of an article IX case. The intention of the negotiators is, however, clear. Unfortunately, there is no echo to the rule in article XXVI (Mutual

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[9] Paragraph 6 of article XI reads as follows:

> For purposes of this Article, interest shall be deemed to arise in a Contracting State when the payer is that State itself, or a political subdivision, local authority or resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a State other than that of which he is a resident a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated and not in the State of which the payer is a resident.

Agreement Procedure), and it is therefore not clear which country should be asked for relief in the first instance. Paragraph 1 contemplates that a party initiating a mutual agreement procedure will be a resident, or at least a national, of one country or the other. Such omissions, though fairly rare in the convention, have surfaced over the years. It is (again) to be hoped that those persons charged with implementing the convention will actively seek ways to further its purposes (or, at least, not actively seek ways to frustrate them).

CONCLUSION

The convention replaced one that had been in place since 1942. That agreement served well over more than 40 years, but economic, tax, and technological developments combined to limit its continuing effectiveness. The 1980 convention obviously will have to withstand every bit as much change and pressure, as the tax laws and situations of Canada and the United States change with a changing world.

We remain hopeful, at this juncture, that the convention will prove adaptable enough to respond to the demands that are being and will continue to be placed upon it. One thing has clearly changed even from the days when the convention was negotiated: the tax policy offices of both Canada and the United States have shown themselves prepared to meet frequently for the purpose of addressing new problems and making protocol amendments to the convention as and when warranted. We have every reason to believe that through such a process the convention may be moulded to fit the requirements of the day and, perhaps, eventually to surpass the 1942 agreement in longevity.

In concluding, we record for future reference some of the issues that have been identified to us that might be addressed in a future protocol, in addition to those specified in the third protocol (rates of withholding tax, the rules in article XXIX A relating to the limitation of benefits, and the possible, but unlikely, implementation of the arbitration procedure as set out in article XXVI):

- the lack of recognition by Canada of limited liability companies as entities qualifying for treaty benefits;
- the denial of deductions in the United States under Treasury regulation 1.882-4, for the failure to file timely tax returns;
- the differences in timing of the income inclusion with respect to benefits under employee stock options between the two countries and in the determination of the source of such income;
- the denial of a full credit for Canadian taxes under the provisions of the US Internal Revenue Code relating to the alternative minimum tax;
- application of the branch-level interest tax in the United States;
- the difficulty encountered by Canadian residents in obtaining a full credit for the US tax on lump-sum distributions under certain employee benefit plans

in the United States, to the extent that the distribution represents a return of employer contributions; and

- application of the convention to electronic commerce transactions.

APPENDIX 1

The New Income Tax Treaty Between the United States and Canada: A U.S. Perspective

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September 18, 1984

I. Preliminary Observations

A. Many exceptional aspects

1. Replaces a treaty that went into effect in 1942, 42 years ago.
2. Required 10 years to negotiate.
3. Faces scores of issues not normally considered in tax treaty negotiations.
   a. Geographical factors (Great Lakes, common borders).
   b. Knowledge of each other's systems (special termination provision).
   c. Breadth of relationships (exempt organizations, "a league with regularly scheduled games in both Contracting States").
   d. Special features of domestic law (section 1504(d)).
   e. Effects of history (real property royalties, grandfathering, transitional rules).
   f. Number of persons affected (U.S. citizens resident in Canada, withholding of taxes in respect of personal services).
   g. Sophistication of the system (reorganizations, distributions from trusts, foreign tax credit).
4. Unusual degree of detail.
5. Importance of the U.S. Technical Explanation.

B. And yet, traditional

1. Squarely modeled on work of the OECD and the U.S. models.
2. Draws upon the 1942 treaty and recent treaties between the treaty partners and other countries (particularly (in both cases), the United Kingdom).
3. Both structure and text are, in essence, the familiar ones.

II. Core of the Agreement

A. For the United States

1. Reduction in source-basis tax dividends and royalties from 15 percent to 10 percent.

2. Expansion of the nondiscrimination provision to include permanent establishments, MFN rule for Canadian corporations owned by residents of the United States and, with restrictions, disbursements paid to the United States.

B. For Canada

1. Ability to tax royalties from natural resources and other real property in excess of 15 percent rate.

2. Deductibility in the United States of expenses incurred with respect to a convention in Canada (see Code section 274(h), enacted by P.L. 96-608).

III. Major Features of Interest to Corporations

A. *Dual residence*. Article IV, para. 3 resolves the issue in accordance with place of "creation," not organization, and thus bars corporate migrations.

B. *Drilling rigs*. Article V, para. 4 sets the permanent establishment test for an "installation or drilling rig or ship" at more than 3 months in any 12-month period.

C. *Permanent establishment in past years*. Article VII, para. 1 states that business profits may be taxed if attributable to a permanent establishment which the taxpayer *had* in the source country.

D. *Nondeductible expenses*. Article VII, para. 3 provides that neither country is required to allow to a permanent establishment a deduction for expenses "not generally allowed under its taxation laws."

E. *Transportation*. Article VIII contains a broad exemption at source for income from international transportation, but allows tax, even without a permanent establishment, if the principal purpose of a voyage is transportation between points in the source country.

F. *Related persons*. Article IX rules apply irrespective of residence.

G. *Correlative adjustments*. Article IX, paras. 3 and 4 gear the provision to the timeliness of notice given to the country asked to adjust; if notice is not given either to the taxpayer or that country, the adjustment must be stricken.

H. *Branch profits*. Article X, para. 6 explicitly covers Canada's tax, with limitations.

I. *Interest*. Article XI, para. 3 subjects the 15 percent tax at source to five exceptions, including interest with respect to sales on credit of equipment, merchandise, or services.

J. *Definition of interest*. Article XI, para. 4 definition is broad, but yields to that of "dividends" as defined in the country where the corporation is resident.

K. *Royalties*. Article XII, para. 3 provides exemption from tax at source on copyright royalties other than motion picture, videotape, and similar royalties.

L. *Rents*. Article XII, para. 4 states that rents from the use of tangible personal property are royalties, not business profits.

M. *Source rule for royalties*. Articles XII, para. 6 superimposes U.S. place-of-use principle on Canadian residence-of-payer rule (subject to an exception for expenses "borne by" a permanent establishment).

N. *Capital gains from disposition of prior permanent establishment*. Article XIII, para. 2 states that gains attributable to business property of a permanent establishment which the taxpayer *had* (within 12 months of the date of disposition) in the source country may be taxed there.

O. *Reorganizations*. Article XIII, para. 8 gives competent authority of the source country authority to defer tax when a corporate reorganization or similar transaction is free of tax in the country of residence.

P. *Capital assets*. Article XIII, para. 9, the fresh start rule, exempts from tax at source all gain attributable to the period ending on December 31, 1984.

Q. *Dependent personal services*. Article XV, para. 2 provides exemption at source if the income is less than $10,000 or the recipient is present in the source country for no more than 183 days and the remuneration is not borne by an employer resident in (or who has a permanent establishment in) that country.

R. *Pension funds*. Article XXI, para. 2 exempts at source dividend and interest income of a pension or other employee benefits plan which is generally exempt from tax in its country of residence.

S. *Foreign tax credit*. Article XXIV allows a credit for taxes imposed by Canada under Parts I, XIII, and XIV of the Income Tax Act, and substantially similar taxes imposed after the date of signature (Sept. 26, 1980); the coverage also includes taxes of general application imposed by political subdivisions and local authorities (Canadian provinces), if substantially similar to the national level taxes and not imposed in a manner inconsistent with the treaty; there is no per country limitation on the credit even if the tax would not be creditable under the Internal Revenue Code; special source rules follow the substantive taxing rights allocated by the treaty, but only for purposes of allowing a credit for Canadian tax.

T. *Nondiscrimination*. Article XXV, para. 8 excepts Canadian rules relating to nondeductibility of interest paid abroad and other measures adopted after Sept. 26, 1980, to ensure that nonresidents are not favored over residents.

U. *Competent authorities*. Article XXVI, para. 3 confers very broad discretion.

V. *Effective dates*. Article XXX makes the treaty effective for taxation at source of dividends, interest, royalties, and pensions and annuities as of October 1, 1984 and as of January 1, 1985 for the remainder; but the 1942 treaty has continuing effect, where it provides greater relief, for a taxpayer's first taxable year beginning on or after January 1, 1985.

IV. The U.S. Technical Explanation

V. The Agreement in Regard to Canadian Taxation of U.S. Offshore Drilling Contractors

Appendix 2

U.S.–Canada: Tax Planning and the New Treaty— A View from the United States

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I. General Observations

A. Adoption of standards are based closely on OECD Model, with the effect, in general, of raising thresholds for source-basis taxation.

B. Substantial delegation of power to competent authorities, with a charge to avoid double taxation and make the treaty work.

C. Importance of the U.S. Technical Explanation.

D. Taxpayers may elect taxation under the Code, but there is some requirement of consistency.

II. Permanent Establishments and Business Profits

A. Delegation of (a) the requirement of an "enterprise" in the country of residence; (b) the "substantial equipment" rule; (c) the rule covering an agent or employee who has a stock of merchandise from which he regularly fills orders; and (d) any specific definition of "business profits" or the like.

B. Special rules for (a) a building site construction or installation project (more than 12 months); and (b) an installation [or] drilling rig or ship (more than 3 months in any 12-month period).

C. Special regime for U.S. drilling rigs operating in Canada does *not* apply.

D. Broad exemption for ancillary activities, including activities of a preparatory or auxiliary character, broadly defined; activities may be combined without creating a permanent establishment.

E. Exemption for "mere" provision of executive, managerial, or administrative facilities or services for the taxpayer.

F. Specific definition of profits "attributable" to a permanent establishment (profits derived from the assets or activities of the permanent establishment); "attribution" may be found even after the permanent establishment ceases to exist.

G. New rule allows taxation of gain from sale of assets of a permanent establishment for twelve months after permanent establishment ceases to exist.

H. Specific discussion of fees for management services and for technical services.

I. Potential importance of treaty rules regarding deductions; change in language makes clear that only otherwise allowable deductions are covered.

III. Special Industry Rules

A. Transportation income regime completely revamped by (a) changing the registration test for ships and aircraft to a residence test; (b) deleting the "enterprise" concept; (c) including income from international transport of containers and related assets; (d) covering gains from alienation, international rental profits, and rental profits incidental to international profits; (e) broadly covering motor vehicle transportation income; and (f) covering temporary rentals of railway rolling stock, motor vehicles, trailers, and containers by any taxpayer.

B. In contrast with the foregoing rules, which allow broader exemption at source, shipping income, where the principal purpose of the voyage was transport in the source country, may be taxed even if no permanent establishment exists.

C. Stringent new rules relating to artists and athletes.

D. Deletion of annual election of "net basis" taxation of real property rentals.

IV. Other Taxation at Source

A. Reduction of tax on direct investment dividends from 15% to 10%.

B. New regime for interest income, allowing for limited classes of exemption (including interest on certain credit sales).

C. Reduction of tax on industrial royalties, broadly defined to include rentals of tangible personal property and royalties from videotapes, from 15% to 10%.

D. Authorization to apply U.S. "second dividend" and "second interest taxes," with some subtle differences between treaty and Code rules.

E. Full source-basis taxation of dividends (but not interest) paid by third-country corporations when subject to the U.S. "second withholding" tax.

F. Full source-basis taxation of other income items not specifically covered by the treaty.

G. New rules allow taxation of dispositions of U.S. real property interests; generally, these mirror the FIRPTA regime, but there is a "fresh start" rule exempt-

ing gains accrued through December 31, 1984, for property held by Canadians (and not forming part of a permanent establishment) on September 26, 1980 and at all times since.

H. Elaborate new "non-discrimination" provisions, with applicability to U.S. real property transactions and potential application to liquidations of Canadian owned U.S. corporations.

V. Important "Procedural" Rules

A. New regime for transfer pricing and other dealings between related parties, with "statute of limitations" on adjustments.

B. Similar regime, without "statute of limitations" feature, for other mutual agreement issues.

C. Flexibility envisioned for cross-border reorganization transactions.

D. Transitional rules, particularly important for U.S. real property transactions.

VI. Other Issues

A. Seconding of employees.

B. Broad new exchange of information rules.

C. Limitation on benefits for Canadian non-resident owned investment corporations.

D. Specific delegation of discretion to competent authorities to settle disputes regarding trusts, estates, and partnerships.