[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND CANADA

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON MAY 25, 1995

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an explanation of the proposed revised third protocol ("proposed protocol") to the income tax treaty between the United States and Canada ("existing treaty"). The proposed protocol was signed on March 17, 1995, The proposed protocol would amend the current U.S.-Canada income tax treaty between the two countries that was signed in 1980 and modified by protocols signed in 1983 and 1984. The proposed protocol revises and replaces the original third protocol that was signed on August 31, 1994, and was pending before the Senate Committee on Foreign Relations at the time of its replacement. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed protocol on May 25, 1995.

Some provisions of the proposed protocol are similar to those in other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty (the "U.S. model"),[2] and the model income tax treaty of the Organization for Economic Cooperation and Development (the "OECD model"). However, the proposed protocol contains certain unique provisions as well as deviations from those models.

Part I of the pamphlet summarizes the principal provisions of the proposed protocol. Part II is a discussion of issues related to the proposed protocol. For a copy of the proposed protocol, see Senate Treaty Doc. 104–4, April 24, 1995. For a detailed, article-by-article explanation of the proposed protocol, see the "Treasury Department Technical Explanation of the Protocol Amending the Convention Between the United States of America and Canada With Respect to Taxes on Income and on Capital Signed at Washington on September 26, 1980, as Amended by the Protocols Signed on June 14, 1983 and March 28, 1984," May 1995 (hereinafter "Technical Explanation").

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada* (JCS–15–95), May 23, 1995.

[2] The U.S. model has been withdrawn from use as a model treaty by the Treasury Department. Accordingly, its provisions may no longer represent the preferred position of U.S. tax treaty negotiations. A new model has not yet been released by the Treasury Department. Pending the release of a new model, comparison of the provisions of the proposed treaty against the provisions of the former U.S. model should be considered in the context of the provisions of comparable recent U.S. treaties.

I. SUMMARY

The proposed protocol differs in certain respects from other U.S. income tax treaties, from the U.S. and OECD model treaties, and from the existing treaty with Canada. A summary of the principal provisions of the proposed protocol, including some of these differences, follows:

(1) Article 1 of the proposed protocol expands the categories of Canadian income taxes generally covered by the treaty to include the taxes imposed under all parts of the Canadian Income Tax Act, and not simply, as under the existing treaty, the income taxes imposed under general income tax portion of the Act and under the portions addressing Canadian income of nonresidents and foreign corporations carrying on business in Canada. The proposed protocol expands the categories of U.S. taxes generally covered to include U.S. estate taxes, to the extent described more fully below. For purposes of the nondiscrimination and exchange of information provisions of the existing treaty, the proposed protocol would expand the categories of Canadian tax covered to include all such taxes, not simply (as under the existing treaty) those imposed under the Income Tax Act. With these expanded provisions, the proposed protocol brings the existing treaty into closer conformity with the U.S. model treaty.

The existing treaty, like other U.S. treaties, also has a provision addressing the applicability of the treaty to taxes that may be imposed by either country in the future, where "the future" means any date after the treaty was signed in 1980. The proposed protocol makes this provision apply to taxes imposed after March 17, 1995, the date that the proposed protocol was signed.

(2) Article XXIV (Elimination of Double Taxation)[3] of the treaty (as it now exists and as it would be amended by the proposed protocol) uses the terms "Canadian tax" and "United States tax" to specify those taxes deemed generally creditable. Under the proposed protocol, however, not all of the existing, generally covered Canadian taxes are taxes the United States regards as creditable income taxes. Article 2 of the proposed protocol modifies the definition of "Canadian tax" in Article III (General Definitions) to ensure that the taxes deemed creditable under the elimination of double taxation article of the existing treaty are only those generally covered Canadian taxes that are in fact taxes on income.

The proposed protocol also modifies the definition of "United States tax" in Article III (General Definitions). The modification is intended to conform Article III to the protocol's rearrangement of the references to U.S. taxes in Article II (Covered Taxes), without changing the significance of the term "United States tax" as it is used in Article XXIV (Elimination of Double Taxation).

(2) Article 3(1) of the proposed protocol adds citizenship in a treaty country to the list of factors that would qualify an individual for treaty benefits as a resident of that country. However, similar to several existing U.S. income tax treaties, the proposed protocol provides that a nonresident of Canada who is a U.S. citizen or green-

[3] Articles numbered by roman numeral are articles of the existing treaty, unless otherwise specified. Articles numbered by arabic numeral are articles of the proposed protocol, unless otherwise specified.

card holder would only be treated as a U.S. resident if the individual has a substantial presence, permanent home, or habitual abode in the United States, and the individual's personal and economic relations are closer to the United States than to any third country.

The proposed protocol adds language to the treaty to confirm interpretations of the existing treaty under which organizations such as governments, pension plans, and nonprofits are treated as residents of the United States or Canada.

Article 3(2) of the proposed protocol amends the existing treaty language under which an otherwise "dual resident company" is treated as a resident of only one country if it was originally created under the laws of that country. Under the protocol, such a company will be deemed to be a resident of the other country if it is "continued" in that other country. The Technical Explanation indicates that the term "continuation" under Canadian law refers to the local incorporation of an entity that is already organized and incorporated under the laws of another country.

(3) Like some other U.S. treaties (such as those with Mexico and Finland), but unlike the OECD and U.S. models, the existing treaty allows each country to impose a time limit on taxpayer claims for refund or other adjustments that arise from (and hence "correlate" to) adjustments previously imposed on a related person by the tax authorities of the other country. The time limit under the existing treaty allows the first country to reject the claim for a correlative adjustment if its tax authority was not notified of the other country's adjustment within 6 years from the end of the taxable year to which the adjustment relates. Furthermore, if the notification is not timely and the taxpayer was not notified by the other country of the adjustment at least 6 months prior to the end of the 6-year period, then (absent fraud, willful default or neglect, or gross negligence) the existing treaty requires the other country to refrain from making its adjustment to the extent that the adjustment would give rise to double taxation.

Article 4 of the proposed protocol would allow the competent authorities to agree that the first country may waive the 6-year notification requirement if the correlative adjustment would not otherwise be barred by its own time or procedural limitations. In addition, the proposed protocol would eliminate the obligation of the other country to refrain from making its original adjustment, and instead simply *permit* the competent authority to provide relief from double taxation "where appropriate."

(5) Article 5 of the proposed protocol generally lowers the existing treaty's 10-percent tax rate on direct investment dividends (i.e., dividends paid to companies resident in the other country that own directly at least 10 percent of the voting stock of the payor) and branch profits taxes. The lower rate under the proposed protocol would be 7 percent in 1995, 6 percent in 1996, and 5 percent (as in the U.S. model treaty and numerous other U.S. treaties) thereafter.

Canada provides special tax benefits to so-called "non-resident-owned investment corporations." Such a corporation is subject to a lower rate of statutory income tax than the general corporate rate (25 percent vs. 38 percent), and is exempt from tax on non-Canadian capital gains. Under Article 5(2) of the proposed protocol, Can-

ada is permitted to impose the existing 10-percent rate, rather than the lowered rate, on a direct investment dividend paid to a U.S. resident by a non-resident-owned investment corporation.

As under other U.S. treaty provisions adopted since 1988, the proposed protocol would permit the United States to impose tax at the rate applicable to "portfolio dividends" (i.e., dividends other than direct investment dividends), in the case of any dividend from a regulated investment company (RIC) or real estate investment trust (REIT). Under the existing treaty, the portfolio dividend tax rate is 15 percent and generally is not altered by the proposed protocol. However, the proposed protocol provides that the general limitation on taxation of portfolio dividends will not apply to a dividend paid by a REIT, except for a dividend that is beneficially owned by an individual holding an interest of less than 10 percent in the REIT (treating as an individual any estate or testamentary trust that acquired its interest in the REIT as a consequence of an individual's death within the previous 5 years).

(6) Article 6(1) of the proposed protocol lowers to 10 percent the existing treaty's generally applicable 15-percent limit on source-country taxation of interest. Article 6(2) of the proposed protocol broadens the existing exemption from source country withholding in the case of the sale of equipment, merchandise or services on credit. Article 6(3) of the proposed protocol conforms to U.S. internal law that requires 30-percent withholding on an excess inclusion of a foreign person with respect to a residual interest in a real estate mortgage investment conduit (a "REMIC"), without reduction under the treaty.

(7) The existing treaty contains a 2-tier limitation on source-country taxation of royalties. Only the residence country may tax royalties and similar payments in respect of the production or reproduction of literary, dramatic, musical or artistic work, if such payments are not in respect of motion pictures or works for use in connection with television). Royalties that do not qualify for the exemption may be taxed by the source country at a rate not to exceed 10 percent. Article 7(1) of the proposed protocol expands the class of payments that qualify for the exemption to include payments for the use of, or the right to use, patents and information (unless provided in connection with a rental or franchise agreement) concerning industrial, commercial or scientific experience, and clarifies that computer software royalties are also included in the exempt class. The proposed protocol permits the treaty countries to agree to add additional payments to the exempt category (by an exchange of diplomatic notes without additional treaty ratification procedures), if they are payments with respect to broadcasting.

The existing treaty includes a source rule for royalties that, similar to U.S. internal law, sources royalties primarily by place of use. Article 7(2) of the proposed protocol, by contrast, introduces a new source rule under which the royalties are sourced primarily by reference to the residence of the payor or the location of a permanent establishment or fixed base of the payor.

(8) To the extent that the existing treaty provides the competent authority of one country the discretion to defer the recognition of the gain or other income on the alienation of property in the course of a corporate organization, reorganization, amalgamation, division

or similar transaction, Article 8 of the proposed protocol provides similar discretion in the case of a comparable transaction involving *non*corporate entities. One practical effect of this change would be to explicitly authorize the exercise of discretion in the case of a reorganization of a Canadian mutual fund organized as a trust.

(9) The existing treaty has a provision limiting source-country taxation of pensions. Article 9(1) of the proposed protocol makes a slight change in the definition of the term "pensions." The protocol clarifies that the definition of pensions includes, for example, payments from a U.S. individual retirement account (an "IRA"), and provides that the definition of pension includes, for example, payments from a Canadian registered retirement savings plan (a "RRSP") or registered retirement income fund (a "RRIF").

The existing treaty has provisions giving sole taxing jurisdiction over social security benefits to the residence country (if paid by the other country), and limiting the taxing jurisdiction of the United States over Canadian social security benefits received by a Canadian resident who is a U.S. citizen. Article 9(2) of the proposed protocol, like most other treaties negotiated since the Social Security Amendments of 1983, eliminates those provisions and gives sole taxing jurisdiction to the source country.

In addition, under present law, certain Canadian retirement plans that are qualified plans for Canadian tax purposes do not meet U.S. internal law requirements of qualification. The existing treaty, however, permits a U.S. taxpayer who is a beneficiary of an RRSP to obtain U.S. tax deferral corresponding to the deferral that the RRSP provides under Canadian tax law, to the extent that income is reasonably attributable to contributions made to the plan by the beneficiary while he was a Canadian resident (see Rev. Proc. 89–45, 1989–2 C.B. 872). The proposed protocol expands the class of retirement or other employee benefit arrangements favored by Canadian law with respect to which the United States will grant corresponding deferral of U.S. tax, and provides that Canada will provide reciprocal treatment to a Canadian taxpayer who is a beneficiary under a pension plan or other arrangement that qualifies for deferral of U.S. tax under U.S. law.

(10) The existing treaty provides that each country generally will exempt dividends and interest from source-country taxation when earned by a trust, company, or other organization constituted and operated exclusively in connection with certain employee benefits, such as pensions. Article 10(1) of the proposed protocol modifies the provision to exempt dividends and interest from source-country *income* taxation, and modifies the description of the payees that are exempted under this provision to refer to a trust, company, organization, or *other arrangement*, generally exempt from income tax, and operated exclusively to administer or provide employee benefits. This is intended to clarify that IRAs, RRSPs, and RRIFs, for example, are intended to benefit from the provision.

The existing treaty provides that a U.S. resident may take a U.S. tax deduction for a charitable contribution to a Canadian organization that could qualify to receive deductible contributions if it were itself a U.S. resident. Article 10(2) of the proposed protocol extends this benefit to a Canadian corporation that is taxed by the United

States as a U.S. corporation under internal U.S. law (e.g., by virtue of an election under Code section 1504(d)).

The existing treaty provides that a Canadian resident must be allowed a Canadian tax deduction for a gift to a U.S. organization that could qualify to receive deductible gifts if it were itself created or established and resident in Canada. Canadian law was changed, since the existing treaty was last amended, to provide a credit, rather than a deduction, for certain gifts. The proposed protocol confirms that Canada is required to provide the appropriate relief—that is, deduction *or* credit—where a gift is made by a Canadian resident to a U.S. organization that could qualify in Canada as a registered charity were itself created or established and resident in Canada.

(11) A nonresident alien individual or foreign corporation generally is subject to U.S. tax on gross U.S. source gambling winnings, collected by withholding. In general, no offsets or refunds are allowed for gambling losses (*Barba v. United States*, 2 Cl. Ct. 674 (1983)). On the other hand, a U.S. citizen, resident, or corporation may be entitled to deduct gambling losses to the extent of gambling winnings (sec. 165(d)). In Canada, an individual may be subject to tax on income derived from gambling only if the gambling activities constitute carrying on a trade or business (e.g., the activities of a bookmaker). Whether gambling activities rise to the level of a trade or business is determined on the facts and circumstances of each case.

Article 11 of the proposed protocol adds a provision not found in any other U.S. treaty or the model treaties, under which the United States must allow a Canadian resident to file a refund claim for U.S. tax withheld, to the extent that the tax would be reduced by deductions for U.S. gambling losses the Canadian resident incurred under the deduction rules that apply to U.S. residents.

(12) Under internal law allowing a credit for foreign income tax, the United States has in the past provided a credit for Canada's social security tax (Rev. Rul. 67–328, 1962–2 C.B. 257). Article 12(1) of the proposed protocol obligates Canada to give a foreign tax credit for U.S. social security taxes paid by individuals (other than taxes relating to unemployment insurance benefits). This rule may have great significance in the case of Canadian residents who commute across the border to employment in the United States.

The proposed protocol makes a number of changes to the article requiring the United States and Canada to provide credits for taxes imposed by the other country or (in Canada's case) corporate tax exemptions for income from U.S. affiliates, generally prompted by changes to U.S. and Canadian internal law since the last amendments to the existing treaty were adopted. The proposed protocol clarifies, for example, that even where the treaty exempts income or capital from taxation in a particular country, that country is nevertheless entitled to take the exempt income or capital into account for purposes of computing the tax on other income or capital.

(13) The existing treaty provides that in computing taxable income, a treaty country must permit a resident to take a deduction for a dependent resident in the other country to the same extent that would be allowed if the dependent resided in the first country. Since the last amendment to the treaty was adopted, the Canadian

law dependent deduction was converted to a dependent credit; that is, a deduction in computing *tax*, as opposed to taxable *income*. Article 13(1) of the proposed protocol confirms that each country is required provide the appropriate deduction—whether from taxable income or simply from tax—for a dependent residing in the other country.

Article 13(2) of the proposed protocol would expand the categories of Canadian taxes covered by the nondiscrimination article to include all taxes, including for example excise and goods and services taxes, rather than only (as under the existing treaty) those imposed under the Income Tax Act. Extension of the nondiscrimination rule to all taxes imposed by a treaty country will also apply to the United States under the proposed protocol, although this is in general already true under the existing treaty, because the existing article applies to all taxes imposed under the Internal Revenue Code.

(14) Like the U.S. treaties with Germany, Netherlands, and Mexico, Article 14(2) of the proposed protocol provides for a binding arbitration procedure to be used to settle disagreements between the two countries regarding the interpretation or application of the treaty. The arbitration procedure can only be invoked by the agreement of both countries. As is true under the treaties with Netherlands and Mexico, the effective date of this provision is delayed until the two countries have agreed that it will take effect, to be evidenced by a future exchange of diplomatic notes.

(15) Article 15 of the proposed protocol adds a treaty provision requiring each country to undertake to lend administrative assistance to the other in collecting taxes covered by the treaty. The assistance provision is substantially broader than the corresponding provisions in the U.S. model treaty and the existing treaty. Although collection assistance provisions like that in the proposed protocol appear in the U.S. treaty with the Netherlands, and to some extent in the present (and proposed) treaties with France and Sweden, entry into a provision such as the one in the proposed protocol, with a country that presently has no similar provision in a treaty with the United States, is a departure from U.S. treaty policy of recent years.

(16) In a departure from the model treaties and other U.S. treaties, Article 16 of the proposed protocol would entitle either treaty country to share information it received from the other country with persons or authorities involved in the assessment, collection, administration, enforcement, or appeals, of state, provincial, or local taxes substantially similar to the taxes covered generally by the treaty as amended by the proposed protocol. This change is in some ways similar to, although significantly narrower than, the proposed protocol with Mexico.

The proposed protocol would expand the categories of Canadian taxes covered by the exchange of information article to include all taxes, including excise and goods and services taxes, rather than (as under the existing treaty) only those imposed under the Income Tax Act and taxes imposed (subsequently repealed) on estates and gifts. As is true in the case of the nondiscrimination article, application of the exchange of information article to all taxes imposed by a treaty country will also apply to the United States under the

proposed protocol, although this is in general already true under the existing treaty, because the existing article applies to all taxes imposed under the Code.

(17) Article 17 of the proposed protocol modifies the provision of the existing treaty relating to miscellaneous rules.

Under U.S. and Canadian internal law, corporate earnings generally are taxed to shareholders only upon distribution. However, a limited class of U.S. small business corporations may elect, under subchapter S of the Code, to have their income taken account by their shareholders, rather than themselves (whether or not the income is distributed), and to exempt from tax their distributions of earnings. In some cases it may be possible for a Canadian resident to be a shareholder in a so-called "S corporation." Article 17(2) of the proposed protocol adds a new provision under which the Canadian tax authorities may agree to impose Canadian income tax on the shareholder using essentially the same timing rules as the U.S. S corporation rules, providing foreign tax credits for the U.S. tax imposed under those rules.

Proposed multilateral trade agreements encompassed in the Uruguay Round Final Act include a proposed General Agreement on Trade in Services ("GATS"). This agreement would obligate members (such as the United States and Canada) and their political subdivisions to afford persons resident in member countries (and related persons) "national treatment" and "most-favored-nation treatment" in certain cases relating to services. If members disagree as to whether a measure falls within the scope of a tax treaty, or if a member considers that another member violates its GATS obligations, then the GATS provides that members will resolve their issues under procedures set up under GATS, with one exception. Disagreements whether a measure falls within the scope of a tax treaty existing on the date of entry into force of the proposed Agreement Establishing the World Trade Organization (January 1, 1995) may be subject to GATS procedures only with the consent of both parties to the tax treaty.

Article 17 of the proposed protocol specifies that for this purpose, a measure would fall within the scope of the existing treaty (as modified by the proposed protocol) if it relates to any tax imposed by Canada or the United States, or to any other tax to which any part of the treaty applies (e.g., a state, provincial, or local tax), but only to the extent that the measure relates to a matter dealt with in the treaty. Moreover, any doubt about the interpretation of this scope is to be resolved between the competent authorities as in any other case of difficulty or doubt arising as to the interpretation or application of the treaty, or under any other procedures agreed to by the two countries, rather than under the procedures of the GATS.

The proposed protocol contains a provision that requires the appropriate authorities to consult on appropriate future changes to the treaty whenever the internal law of one of the treaty countries is changed in a way that unilaterally removes or significantly limits any material benefit otherwise provided under the treaty. This provision corresponds to provisions in U.S. treaties with the Netherlands, Mexico, and Israel that contemplate further negotiations in the event of relevant changes to internal law.

(18) Article 18 of the proposed protocol contains a limitation on benefits, or "anti-treaty-shopping" article that permits the United States to deny treaty benefits to a resident of Canada unless requirements, similar in many respects to those contained in recent U.S. treaties and in the branch tax provisions of the Code, are met. This provision replaces very limited anti-abuse provisions denying benefits under the existing treaty. The proposed protocol includes a derivative benefits provision. It is similar in some respects to, and different in other respects from, the derivative benefits provisions in the anti-treaty-shopping articles of the Netherlands and Mexico treaties. Unlike most other corresponding U.S. treaty provisions, the proposed anti-treaty-shopping article does not entitle Canada to deny any treaty benefits. The proposed protocol indicates, and the Technical Explanation clarifies, that both countries may deny benefits under otherwise applicable anti-abuse principles.

(19) Canada does not impose an estate tax. For Canadian income tax purposes, however, capital assets of a decedent are deemed to have been disposed of immediately before death. Thus, gains inherent in capital assets held at death generally are subject to Canadian income tax. Article 19 of the proposed protocol is intended to coordinate the U.S estate tax with the Canadian income tax upon gains deemed realized at death. In this respect, the proposed protocol is unique; the United States has not previously coordinated its estate tax by treaty with any country that does not itself impose an estate or inheritance tax.

The estate tax coordination rules apply to residents of the United States and of Canada as defined in the existing treaty (as modified by the protocol, as noted above). The treaty's residence rules are somewhat different than the residence rules that apply for estate tax purposes under the Code or under most U.S. estate tax treaties.

The proposed protocol would obligate Canada and the United States to treat a decedent's bequest to a religious, scientific, literary, educational, or charitable organization resident in the other country in the same manner as if the organization were a resident of the first country. Thus, for U.S. estate tax purposes, a deduction generally would be allowed for a bequest by a Canadian resident to a qualifying exempt organization resident in Canada, provided the property constituting the bequest is subject to U.S. estate tax.

In general, U.S. citizens and residents are allowed a unified credit of $192,800 against their cumulative lifetime U.S. estate and gift tax liability. Nonresident aliens generally are allowed a credit of $13,000 against the U.S. estate tax. For U.S. estate tax purposes, the proposed protocol generally would provide Canadian residents who are not United States citizens with a pro rata portion of the unified credit allowed to U.S. citizens and residents.[4] The pro rata portion would be based upon the ratio that the Canadian resident's gross estate situated in the United States bears to his worldwide gross estate. This credit must be reduced for any gift tax unified credit previously allowed for any gift made by the decedent. Also, the credit may not exceed the U.S. estate tax imposed on the dece-

[4] The credit allowed to a Canadian resident would be not less than $13,000.

dent's estate. Allowance of the pro rata unified credit is conditioned upon the taxpayer providing sufficient documentation to verify the amount of the credit. This provision is consistent with the regime contemplated by Congress in passing Code section 2102(c)(3).

Since enactment of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), the general 100-percent marital deduction from the U.S. estate and gift tax has been substantially limited in the case of property passing to a noncitizen spouse. The proposed protocol allows an estate to elect a limited estate tax marital credit for property that would qualify for the marital deduction if the surviving spouse had been a U.S. citizen, provided the following conditions are met: (1) the surviving spouse is a resident of one of the treaty countries, (2) the decedent spouse was a U.S. citizen or a resident of one of the treaty countries, (3) where both spouses are U.S. residents, at least one spouse is a citizen of Canada, and (4) the executor of the decedent's estate irrevocably waives any estate tax marital deduction that may be allowed under the Code. In general, the credit is the lesser of the decedent's unified credit (allowed under the proposed protocol or under U.S. domestic law), or the estate tax that would otherwise be imposed on the marital transfer.

The United States by statute allows a foreign tax credit against U.S. estate tax for foreign estate, inheritance, legacy or succession taxes (sec. 2014). Imposition of the Canadian income tax on deemed dispositions at death is not presently creditable under section 2014 (Rev. Rul. 82–82, 82–1 C.B. 127).[5] Under the proposed protocol, the estate of a U.S. citizen or resident (or the estate of a surviving spouse with respect to a qualified domestic trust) would receive a U.S. estate tax credit for the Canadian Federal and provincial income taxes imposed at the decedent's death with respect to property situated outside of the United States. The credit is limited to the amount of U.S. estate tax that is imposed on the decedent's estate situated outside the United States. Also, no credit against U.S. estate tax generally may be claimed to the extent that a credit or deduction for the Canadian tax is claimed against U.S. income tax.

Under the U.S. model estate and gift tax treaty, the United States would exempt the estate of a decedent domiciled in the other country from U.S. estate tax, except to the extent that the decedent's estate consists of real property situated in the United States or assets that are part of the business property of a permanent establishment or fixed base in the United States. The proposed protocol would extend this treatment to the estate of a Canadian resident (who is not a citizen of the United States), but only if the value of the decedent's worldwide gross estate does not exceed $1.2 million.

The Canadian income tax on gain from the deemed disposition of property of a decedent may, in effect, be deferred if the property passes to the surviving spouse or a "spousal trust." Under the proposed protocol, a qualified domestic trust for U.S. estate tax purposes generally may be treated as a "spousal trust" for Canadian tax purposes. Thus, the proposed protocol would enable a transfer to a trust on behalf of a non-U.S. citizen spouse to qualify simulta-

[5] The United States by statute also allows a foreign tax credit against U.S. income tax for foreign income taxes (sec. 901). The Canadian income tax on deemed dispositions at death generally is creditable under section 901.

neously for the U.S. estate tax marital deduction and for deferral of the Canadian income tax on gains deemed realized at death.

Canada, like the United States, generally gives a foreign tax credit against the income tax only for foreign income tax. The proposed protocol would require Canada to give a Canadian resident decedent (and a Canadian resident spousal trust) a limited income tax credit for certain U.S. estate taxes. The credit generally is limited to the amount of Canadian income tax (after reduction by credit for U.S. income tax) that is imposed on income that the United States is entitled (without regard to the saving clause) to subject to estate tax under the treaty. If the decedent is subject to U.S. estate tax on property other than that situated in the United States, the amount of U.S. estate tax that Canada must credit against income tax is limited to that portion of the U.S. tax imposed on U.S.-situs property.

(20) Article 20 of the proposed protocol requires the appropriate authorities of Canada and the United States to consult within 3 years with respect to further reductions in withholding taxes, and with respect to the limitation on benefit rules. They are to consult after 3 years also to determine whether to make the arbitration provision effective through an exchange of diplomatic notes.

(21) The proposed protocol generally enters into force upon the exchange of instruments of ratification.

The provisions under the proposed protocol relating to withholding on dividends, interest, royalties and pensions and annuities (other than social security benefits) generally would apply with respect to amounts paid or credited on or after the first day of the second month after the protocol enters into force. A phase-down of the withholding rate would apply with respect to certain dividends (if the beneficial owner is a company, other than a partnership, that holds directly at least 10 percent of the paying company's capital). Under the phase-down, the rate after the above general effective date and before 1996 would be 7 percent, and the rate after 1995 and before 1997 would be 6 percent. Thereafter the rate would be 5 percent.

For other taxes, the proposed protocol generally would be effective for taxable years beginning on or after the first day of January after the protocol enters into force. A different phase-down of the rate would apply to amounts taxed under Article X, paragraph 6 of the existing treaty (relating to the branch tax, as amended by the protocol); under this phase-down, the applicable rate would be 6 percent for taxable years beginning after the general effective date (above) and ending before 1997, and 5 percent thereafter.

The provision relating to assistance in collection (Article 15 of the proposed protocol) would be effective for revenue claims finally determined after the date that is 10 years before the date on which the proposed protocol enters into force.

Provisions relating to taxes imposed by reason of death (Article 19 of the proposed protocol, other than paragraph 1 of Article 19 (relating to property passing to an exempt organization by reason of an individual's death), and certain related provisions) generally would be effective with respect to deaths occurring after the date on which the proposed protocol enters into force. If a claim for refund is filed within one year after the date on which the proposed

protocol enters into force, or within the otherwise applicable period for filing such claims under domestic law, then these provisions would be effective with respect to deaths occurring after November 10, 1988, notwithstanding any limitation under internal Canadian or U.S. law on the assessment, reassessment or refund with respect to a person's return.

II. ISSUES

The proposed protocol between the United States and Canada presents the following issues:

A. Taxes Imposed by Reason of Death

In general

Until 1972, Canada had a succession duty. At that time, Canada instituted a system under which, instead of imposing an estate tax, capital property of a decedent is deemed, for *income* tax purposes, to have been disposed of immediately before death. Thus, any gains inherent in capital assets held at death generally are subject to Canadian income tax (the "gains at death tax").[6]

The United States and Canada previously had been parties to bilateral estate tax treaties, the last of which was terminated effective in 1985. Article 19 of the proposed protocol would once again provide in certain cases for the reduction of U.S. estate tax on the estate of a decedent who is a resident of Canada; it would also in certain cases provide for the reduction of the Canadian income tax on gains deemed realized at death with respect to the estate of a person that is liable for U.S. estate tax.

A principal purpose of the proposed protocol is to coordinate the U.S. estate tax with the Canadian gains at death tax. In this respect, the proposed protocol is unique; it is the first time the United States has entered into a tax treaty covering estate taxes with a country that does not impose an estate or inheritance tax. The issue is whether the coordination of the two taxes is necessary, and, if so, are the concessions granted by the United States appropriate to achieve coordination. A risk also exists that the proposed protocol could be viewed as a precedent by other countries that do not impose estate or inheritance taxes and that they could put pressure on the United States to grant them similar concessions. The Committee may wish to consider whether the special relationship between the United States and Canada and the desirability of coordination of the two death tax regimes warrant establishing this precedent.

Charitable bequests

Under paragraph 1 of the proposed protocol, a charitable bequest by a resident of either the United States or Canada to a qualifying exempt organization of the other country will be treated as if the exempt organization was a resident of the first country. A similar provision already exists for income tax purposes under Article XXI of the existing treaty between the United States and Canada. It is anticipated that the determination of an organization's exempt status for purposes of this charitable bequest provision will be made in the same manner as under the provisions of Article XXI for income tax purposes. Thus, this provision can be viewed as a logical extension of the provision in the existing treaty.

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[6] With respect to certain transfers to spouses or "spousal trusts," no tax is imposed because the amount deemed realized is the decedent's basis in the property; the spouse or spousal trust obtains a carryover basis.

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Although this provision appears on its face to grant reciprocal benefits, it is in effect only a concession by the United States to allow a U.S. estate tax deduction for charitable bequests by a Canadian resident to a qualifying Canadian resident organization.[7] Charitable bequests by Canadian residents to qualifying U.S. resident organizations are already deductible from the Canadian gains at death tax under the terms of the existing treaty.

A similar provision is contained in the U.S. model estate and gift tax treaty and several other existing U.S. estate and gift tax treaties, including the treaties with Denmark, France, Germany and Sweden.[8]

Pro rata unified credit

In TAMRA, Congress passed Code section 2102(c)(3) which permits a "pro rata" unified credit for nonresidents to the extent provided by treaty. The pro rata unified credit equals the unified credit allowed to U.S. citizens and residents multiplied by the fraction of the total worldwide gross estate situated in the United States. Apparently, Congress believed it was appropriate to allow a proportionate credit where the information-sharing under treaties would allow the worldwide estate to be "easily determinable." See Conference Report on H.R. 4333, H.R. Rep. 100–1104, 100th Cong., 2d Sess. 116 (1988).

Paragraph 2 of the proposed protocol would provide a pro rata unified credit to Canadian residents who are not U.S. citizens.[9] This would be the first time that a pro rata unified credit has been granted expressly by treaty. However, several existing estate and gift tax treaties (e.g., Australia, Finland, Greece, Italy, Japan and Norway) contain provisions that allow residents of a treaty country a pro rata portion of "specific exemptions" granted by the other country. These provisions have been interpreted as granting a pro rata unified credit for U.S. estate tax purposes to residents of the U.S. treaty partners. *Mudry v. United States.* 1 Cl. Ct. 207 (1986); *Estate of Burghardt v. Commissioner*, 80 T.C. 705 (1983), *aff'd* 734 F. 2d 3 (3d Cir. 1984); Rev. Rul. 90–101, 1990–2 C.B. 315.[10]

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[7] Under Code section 2055, charitable bequests by a U.S. citizen or resident to a qualifying Canadian resident organization are deductible for U.S. estate tax purposes in determining the decedent's taxable estate.

[8] The Committee previously has expressed reservations about adopting similar provisions with respect to income tax treaties. This is because these treaty provisions typically grant U.S. persons a right to a deduction they are not entitled to under the Code—a deduction for charitable contributions to non-domestic qualifying organizations. The Committee has stated that it is "deeply concerned about the granting of deductions to U.S. persons by treaty where the Code does not otherwise grant the deductions." See *Report of the Senate Committee on Foreign Relations, Accompanying the 1980 U.S.-Canada Income Tax Treaty and 1983 and 1984 Protocols*, Exec. Rep. No. 98–22, 98th Cong., 2d Sess., 8–9 (1984). Thus, with respect to U.S. income tax treaties, this type of provision is found only in the existing U.S. tax treaty with Canada and the U.S. tax treaties with Israel and Mexico.

In contrast, the proposed protocol does not grant U.S. persons a deduction they are not otherwise entitled to under the Code. Charitable bequests by U.S. persons to a qualifying Canadian resident organization are already deductible for U.S. estate tax purposes under Code section 2055. Thus, the reservations previously expressed by the Committee with respect to income tax treaties are not applicable to this provision of the proposed protocol.

[9] The saving clause of the proposed protocol preserves the ability of the United States to reduce the unified credit allowable to $13,000 under section 2107 with respect to citizens who have expatriated to Canada within the past ten years.

[10] The IRS previously had taken the position that the unified credit was not a "specific exemption" covered by the treaties. Thus, it had held that residents of the U.S. treaty partners were only entitled to the smaller exemption specifically allowed to nonresidents under the Code. Rev. Rul. 81–303, 1981–2 C.B. 255.

Thus, the proposed protocol appears consistent with both the legislative intent in passing TAMRA and the treatment under several existing U.S. estate and gift tax treaties. As has been noted above, however, the proposed protocol is the first treaty covering U.S. estate and gift taxes with a treaty partner that does not itself impose an estate or inheritance tax. It is unclear from the legislative history of TAMRA whether Congress anticipated that pro rata unified credits would be granted by treaty where the other country does not impose an estate or inheritance tax. The Committee may wish to consider whether granting a pro rata unified credit to residents of a country that does not itself impose an estate or inheritance tax is an appropriate tax treaty policy.

Under the proposed protocol, it appears that assets exempted from the estate tax under the treaty (e.g., under paragraph 8 of this article) would still be taken into account in the numerator for purposes of computing the unified credit. A proposed technical correction to section 2102(c)(3) presently under consideration by Congress would clarify that, in determining the pro rata unified credit under a treaty, property exempted by the treaty from U.S. estate tax would not be treated as situated in the United States. H.R. 1215, 104th Cong., 1st Sess. sec. 604(f)(1) (1995). The House Ways and Means Committee Report states that the technical correction is not intended "to affect existing treaties containing pro rata exemptions, because in those treaties taxation follows situs. For future treaties, the committee intends that any pro rata unified credit negotiated not exceed the proportion of the gross worldwide estate subject to U.S. estate and gift tax, as modified by treaty." See H.R. Rep. 104–84, 104th Cong., 1st Sess. 93–94 (1995).

The proposed protocol is not the same type of treaty as the "existing" treaties referred to in the Committee Report. Those "existing" treaties (e.g., Italy) specifically describe the assets reserved for situs taxation by the non-domiciliary country. Thus, under those treaties, it is clear (without application of the proposed technical correction) that exempt assets would not be included in the numerator for computing a pro rata exemption. In contrast, exempt assets apparently would still be included in the numerator under the proposed protocol because the situs of assets would be determined under domestic law. Thus, consistent with the intent of the proposed technical correction, it may be appropriate to clarify that exempt assets would be excluded from the numerator in computing the pro rata unified credit under the proposed protocol.[11] The Committee may wish to express its views whether such clarification should be made as part of the treaty ratification process or in future legislation.

[11] If the proposed protocol is ratified after passage of the proposed technical correction, the proposed protocol likely would be treated as superseding the technical correction and thus, without clarification, exempt assets would be included in the numerator. If the proposed protocol is ratified prior to passage of the proposed technical correction, the proposed protocol may be treated as superseded by the technical correction and thus exempt assets would be excluded from the numerator. However, if ratification of the protocol precedes the passage of the technical correction, it is also possible to argue that the term "existing" treaties as used in the Committee Report includes the proposed protocol and thus exempt assets should not be included in the numerator. Accordingly, clarification is needed in either circumstance, i.e., where ratification of the proposed protocol precedes passage of the technical correction or vice versa.

Estate tax marital credit for Canadian residents

To determine the taxable estate of a decedent for U.S. estate tax purposes, a deduction generally is allowed for the value of any property that passes to his or her surviving spouse. TAMRA, however, eliminated this marital deduction where the surviving spouse is not a U.S. citizen (except for transfers to a "qualified domestic trust" ("QDOT")[12] or where the surviving spouse becomes a U.S. citizen). Several countries have sought U.S. treaty relief from this TAMRA provision, including some countries with pre-TAMRA U.S. estate tax treaties that have provisions relating to the marital deduction. The proposed protocol would contain the first agreement by the United States to provide such relief. Thus, the proposed protocol may be viewed as a precedent by other countries seeking treaty relief from TAMRA. The Committee may wish to clarify that the granting of the marital deduction in the proposed protocol may be appropriate in part because of the special relationship between the United States and Canada, and should not necessarily be viewed as a precedent by other countries.

Paragraphs 3 and 4 of the proposed protocol would provide a marital credit against the U.S. estate tax on property passing to a noncitizen spouse if the decedent and the surviving spouse meet certain requirements regarding residency and citizenship. In addition, the credit is available only if the executor of the decedent's estate irrevocably waives the benefits of any estate tax marital deduction that may otherwise be allowed.

The credit that would be allowed under the treaty equals the lesser of (1) the same amount as the pro rata unified credit allowable under the proposed protocol or under U.S. domestic law, and (2) the amount of the U.S. estate tax that would otherwise be imposed on the qualifying property transferred to the spouse. The marital credit would be in addition to any amount that would be exempted by the unified credit. Thus, the marital credit effectively would grant couples covered by the treaty a proportionate share (based on the portion of their gross estate situated in the U.S.) of the same aggregate $1.2 million estate tax exemption allowed to U.S. citizen couples.[13] This provision is similar to the approach taken in recent proposed legislation to grant a limited marital transfer credit to employees of "qualified international organizations." See, e.g., H.R. 770, 103d Cong., 1st Sess. (1993). The credit amount also generally would be sufficient to resolve a principal area of concern—the reduction of the estate tax burden on transfers of personal residences and retirement annuities. Thus, it may be argued that the proposed protocol takes a reasonable approach and sets the credit at an appropriate level. Once again, however, the Committee may wish to consider whether the United States should grant this type of credit in a treaty with a country that does not itself impose an estate or inheritance tax.

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[12] A trust may qualify as a QDOT if it has at least one trustee that is a U.S. citizen or a domestic corporation and if no distributions of corpus can be made unless the U.S. trustee may withhold the tax from those distributions. Section 2056A.

[13] Because of the graduated estate tax rate structure, full availability and use of both credits will never completely shelter the U.S. estate tax on a $1.2 million gross estate. See example 2 of the Technical Explanation.

Treatment of certain transfers to spouses

For purposes of the Canadian gains at death tax, Canada grants an exemption for transfers to surviving spouses and "spousal trusts," provided that both the decedent and the spouse (or the spousal trust, as applicable) were residents of Canada immediately before the decedent's death. Thus, under present Canadian law, a transfer from a Canadian resident decedent to a U.S. resident spouse or from a U.S. resident decedent to a Canadian resident spouse will not qualify for the marital exemption.[14]

Paragraph 5 of the proposed protocol would exempt from the gains at death tax deathtime transfers to a spouse where the decedent was a resident of the United States immediately before death. Thus, transfers from a U.S. resident decedent to a Canadian resident spouse (or for that matter a spouse with any residence) would qualify for exemption. The converse, however, is not true—a transfer from a Canadian resident decedent to a U.S. resident spouse would not qualify for exemption.

A spousal trust is treated as resident in Canada if the trustee is a Canadian resident or a Canadian corporation. Upon request by a U.S. resident trust, the Canadian competent authority may agree, under the proposed protocol, to treat the trust as a Canadian resident trust (i.e., by treating its trustee as a Canadian resident) for purposes of the exemption from the gains at death tax. The Canadian competent authority also can refuse to grant treatment as a Canadian resident trust if the trust does not meet "terms and conditions satisfactory to such competent authority." The Technical Explanation states that this provision is "intended to enable a trust that is a qualified domestic trust for U.S. estate tax purposes to be treated at the same time as a spousal trust" for purposes of the gains at death tax. The proposed protocol, however, provides no standards for the Canadian competent authority to apply in agreeing or refusing to treat a QDOT as a spousal trust. Thus, it is unclear under the proposed protocol when a QDOT would qualify as a spousal trust. The Committee may wish to express its views regarding the types of terms and conditions that it expects may be required of a QDOT by the Canadian competent authority for treatment as a spousal trust.

Canadian gains at death tax credit for estate tax credit

Paragraph 6 of the proposed protocol is a reciprocal concession by Canada for the U.S. estate tax credit granted under paragraph 7 for payments of the Canadian gains at death tax. Under paragraph 6, Canadian residents and Canadian resident spousal trusts would receive a credit for U.S. estate taxes and state inheritance taxes imposed with respect to U.S. situs property. The credit is only available where the U.S. tax is imposed upon the decedent's death or, in the case of a spousal trust, upon the death of the surviving spouse. Thus, for reasons similar to those discussed below with respect to paragraph 7, availability of the credit for U.S. estate and inheritance taxes would be dependent upon when the relevant taxes are imposed. In situations where the taxes are imposed be-

[14] Nonresidents generally are subject to the gains at death tax on certain Canadian situs property.

tween the deaths of the two spouses, the credit apparently would not be available (absent competent authority relief).

Estate tax credit for Canadian gains at death tax

Paragraph 7 of the proposed protocol would provide in certain cases a U.S. estate tax credit for the Canadian Federal and provincial gains at death taxes. The credit would be available only with respect to (1) a U.S. estate tax that is imposed either by reason of the death of an individual who was a U.S. citizen or resident at the time of the decedent's death, or (2) the U.S. estate tax imposed with respect to property remaining in the QDOT at the time of the death of the surviving spouse.

To qualify for the credit, the Canadian taxes must be imposed at the death of the decedent, or the death of the surviving spouse in the case of taxes imposed with respect to property remaining in the QDOT. In addition, the Canadian gains at death taxes must be imposed on property situated outside the United States which is subject to the U.S. estate tax. The Canadian gains at death taxes would be creditable against the U.S. estate tax regardless of whether the taxable event and the identity of the taxpayer are the same under Canadian law as under U.S. law. The amount of the allowable credit would be computed in accordance with the provisions and subject to the limitations of U.S. internal law, except that the Canadian gains at death tax would be treated as "a creditable tax" under U.S. internal law as if it were a death tax rather than an income tax.

The proposed protocol generally would prevent a taxpayer from taking either a deduction or a credit for the same Canadian death tax against both his U.S. income tax and his estate tax liability. An exception would be available for the estate tax imposed on the QDOT at the death of the surviving spouse. No interest would be paid on any refunds of U.S. tax resulting from the credit for Canadian gains at death taxes.

Marital transfers

Under the proposed protocol, the availability of the Canadian gains at death tax credit would be dependent upon when the U.S. estate tax is imposed and when the Canadian gains at death tax is imposed. There are nine different combinations of when these two taxes can be imposed with respect to marital transfers.[15] The following discussion illustrates each of these possible combinations and the tax consequences of each under the proposed protocol. For purposes of each example, assume the following facts: an individual resident of the United States owns Canadian real property; the individual's spouse is not a U.S. citizen; the credit, if available would be claimed within the 4-year limitation period under section 2014(e);[16] and U.S. tax is not eliminated by the application of any

[15] The nine different combinations arise because the U.S. estate tax can be imposed on a marital transfer at three different times (date of death of first spouse, corpus distributions from QDOT between the deaths of spouses, and the date of death of second spouse) and the Canadian gains at death taxes also can be imposed at three different times (date of death of first spouse, sale of assets by spousal trust between deaths of spouses, and the date of death of second spouse).

[16] Under Code section 2014(e), the credit for foreign death taxes generally is only allowed with respect to foreign death taxes that are paid and for which credit is claimed within 4 years after the filing of the estate tax return.

available credits under the proposed protocol and U.S. internal law.[17]

(1) *U.S. estate tax and Canadian gains at death tax both imposed at death of first spouse*

This result could occur where there is a marital bequest to a trust, the QDOT election is not made, and the trust does not qualify for carryover basis under Canadian law (e.g., the Canadian competent authorities do not agree to treat the trust as a spousal trust).[18] In such a case, both U.S. estate tax and Canadian death tax are imposed at the death of the first spouse.

A foreign death tax credit would be allowed under the proposed protocol for the Canadian death tax imposed on the estate of the first spouse. All the conditions stipulated by paragraph 7 of the proposed protocol are satisfied.

(2) *U.S. estate tax imposed at death of first spouse; Canadian gains at death tax imposed on sale of assets between death of spouses*

This case might arise where the property is transferred to a trust that meets the spousal trust requirements for Canadian tax purposes, but no QDOT election is made for U.S. tax purposes. The trust subsequently sells the property before the second spouse dies.

The amount of Canadian death tax would not be allowed as a credit under the proposed protocol, because the Canadian gains at death tax is not imposed at the death of either the first or second spouse. However, the competent authorities of the two countries may decide to grant relief under the proposed protocol.[19] This analysis holds for all of the scenarios where the Canadian gains at death tax is imposed on the sale of an asset between the date of the two spouses' deaths (scenarios 5 and 8 below).

(3) *U.S. estate tax imposed at death of first spouse; Canadian gains at death tax imposed on death of second spouse*

This case might arise where the property is transferred to a trust that meets the spousal trust requirements for Canadian tax purposes, but no QDOT election is made for U.S. tax purposes and the trust holds the property until the second spouse dies.

A foreign death tax credit would appear to be allowed under the proposed protocol for the Canadian death tax imposed on the spousal trust.

[17] The hypothetical situations described below as possibly resulting in the timing results at issue are included only as examples, and are not meant to suggest that other facts would not also be accompanied by the same timing results. Furthermore, the analysis provided in each case only pertains to the specific fact patterns described.

[18] This is also the typical *non*-marital case in which a decedent passes away and his assets are inherited by someone other than his spouse; no deferral of either the U.S. estate tax or the Canadian death tax is available.

[19] Article 14 of the proposed protocol states that competent authority relief may be sought in cases where double taxation results from differences in the tax laws of the United States and Canada due to "dispositions or distributions" of property by a QDOT or a spousal trust.

(4) U.S. estate tax imposed on corpus distributions from QDOT; Canadian gains at death tax imposed at death of first spouse

This case might arise where the property is transferred to a trust that meets the requirements of a QDOT, but not those of a Canadian spousal trust (e.g., the Canadian competent authorities do not agree to treat the trust as a spousal trust), and there is a corpus distribution between the spouses' deaths.

The credit for Canadian gains at death taxes apparently would not be allowed under the proposed protocol because the U.S. estate tax (against which the Canadian tax would be credited) is not imposed by reason of the death of the first spouse or imposed on the QDOT upon the death of the surviving spouse. Rather, the U.S. estate tax sought to be reduced is being imposed on the QDOT under section 2056A(b)(1)(A) on the distribution of property from the QDOT. Thus, a credit would be allowable only if the QDOT tax imposed under section 2056A(b)(1)(A) is somehow deemed to be the same as imposition of the estate tax upon the death of the first spouse. It does not appear that this is the result under either the internal U.S. law or the proposed protocol.

As discussed previously, competent authority relief may be available under the proposed protocol.

(5) U.S. estate tax imposed on corpus distributions from QDOT; Canadian gains at death tax imposed upon sale of assets between spouses' deaths

This case is likely to occur where property is transferred to a trust which qualifies as both a QDOT for U.S. estate purposes and a spousal trust for Canadian death tax purposes, and the trust sells the property and distributes the proceeds to the second spouse before his or her death.

The credit for Canadian gains at death taxes would not be available under the proposed protocol for two reasons. First, as in scenario 4, the U.S. estate tax is not imposed by reason of the death of either spouse. In addition, as in scenario 2, the Canadian tax also is not imposed by reason of the death of either spouse. However, as discussed previously, competent authority relief may be available under the proposed protocol.

(6) U.S. estate tax imposed on corpus distributions from QDOT; Canadian gains at death tax imposed at death of second spouse

This case might arise where the trustee of the QDOT/spousal trust distributed property in-kind to the second spouse. There would be U.S. estate tax on the corpus distribution, but there may not be a Canadian capital gains tax until there is a disposition of the property by the second spouse or the second spouse dies.

As in scenario 4, the credit apparently would not be available because the U.S. estate tax is not imposed upon the death of either spouse. Competent authority relief may be available.

(7) *U.S. estate tax imposed at death of second spouse; Canadian gains at death tax imposed at death of first spouse*

This case may occur where the property is transferred to a trust that meets the requirements of a QDOT, but not those of a Canadian spousal trust (e.g., the Canadian competent authorities do not agree to treat the trust as a spousal trust), and the trust holds the property without distributions until the death of the second spouse.

A credit would be allowed under the proposed protocol for the Canadian gains at death tax imposed on the estate of the first spouse. All the conditions of the proposed protocol are satisfied.

(8) *U.S. estate tax imposed at death of second spouse; Canadian gains at death tax imposed on sale of assets between death of spouses*

This case is likely to arise where property in the QDOT/spousal trust is sold and the proceeds retained in the trust until the death of the second spouse.

The credit would not be available because the Canadian tax is not imposed upon the death of either spouse. As under scenario 2, competent authority relief may be sought.

(9) *Both U.S. estate tax and Canadian gains at death tax imposed at death of second spouse*

This is the typical case of the QDOT/spousal trust that holds the property throughout the remaining lifetime of the second spouse. There will be a U.S. QDOT estate tax and a Canadian death tax imposed at the death of the second spouse.

A credit would be allowed under the proposed protocol for the Canadian gains at death taxes imposed on the spousal trust on the death of the second spouse. All the conditions required by the proposed protocol are satisfied.

Estate tax exemption for small estates

Paragraph 8 of new Article XXIX B would limit the U.S. estate tax that could be imposed on Canadian residents with small gross estates. Under this provision, if the worldwide estate of a Canadian resident is equal to or less than $1.2 million, the U.S. estate tax would only apply to any U.S. real estate or U.S. business property of a permanent establishment or fixed base in the United States. Gains on those two types of property are the only gains on which the situs country is permitted to impose income tax, including the gains at death tax, under Article XIII of the existing treaty.

Paragraph 8 is similar to a provision contained in the U.S. model estate tax treaty and other U.S. estate tax treaties, except that those treaties generally do not impose a limitation on the size of the estate. More importantly, the provision in the model treaty (and other similar treaties) are reciprocal concessions granted with respect to each country's estate tax. Because Canada imposes no estate tax, the concession in Paragraph 8 relates only to U.S. estate tax; however, as noted above, Canada already grants a similar concession with respect to the gains at death tax under the existing treaty.

The provision has the anomalous effect of potentially treating Canadian residents with U.S. situs assets better than U.S. citizens and residents with similar U.S. situs assets. For example, assume that an unmarried decedent has an estate comprised entirely of $1.2 million worth of stock in a U.S. corporation. Assume that he has a basis in the shares of stock of $1.1 million and that he has $100,000 in deductions for U.S. estate tax purposes. If the decedent were a U.S. citizen or resident, he would pay U.S. estate tax at an average rate of approximately 39 percent on $500,000 (i.e., $1.1 million taxable estate less $600,000 unified credit exemption equivalent). In contrast, if he were a Canadian resident, he would pay no U.S. estate tax under the proposed protocol (because the stock would be exempt property under paragraph 8) and would be subject to Canadian gains at death tax on only $100,000 (i.e., $1.2 million in value of stock less $1.1 million basis in stock).

This is the first time the United States has made this type of concession with a country that does not itself impose an estate or inheritance tax. As a result, and in light of the foregoing, the Committee may wish to consider whether the special relationship between the United States and Canada warrants establishing this precedent.

This provision would benefit individuals with small estates who are treated as residents in the United States at death under U.S. internal estate tax law, but are treated as Canadian residents under the treaty.[20] This provision, however, provides no benefit to a decedent who is a U.S. resident under the treaty definition but not under the U.S. estate tax definition. Such a person would not qualify for the small estate exemption; only Canadian residents (as defined by the treaty) may qualify.

The ability of the IRS to administer the limitation on the size of the estates that qualify for exemption will be dependent on information-sharing with the Canadian tax authorities.[21] For example, if a Canadian resident decedent has significant assets in a third country, the IRS may have trouble verifying that his or her estate is less than $1.2 million, without information sharing with Canada. The staff understands that information-sharing with Canada has worked well in the past.

Effective date

The provisions of the proposed protocol relating to taxes imposed at death generally would be effective on a prospective basis. At the election of the taxpayer, however, all of these provisions (other than paragraph 1 applicable to charitable bequests) could be applied retroactively to the date of the enactment of TAMRA.[22] Thus, the retroactive effective date would apply reciprocally to the concessions made by the United States and the concessions made by Canada. Moreover, the retroactive relief would apply even to provisions

[20] This can occur, because as noted above, the existing treaty and proposed protocol use an income tax definition of residency, rather than an estate tax definition.

[21] The same problem generally would arise with respect to determining the worldwide estate for computing the pro rata unified credit. Unlike the small estate exemption, however, the availability of the pro rata unified credit under the proposed protocol is conditioned upon the taxpayer providing sufficient verification of his worldwide estate.

[22] To qualify, a taxpayer must file a claim for refund by the later of one year from the date that the proposed protocol enters into force or the date that such a claim must be filed under Canadian or U.S. law, as applicable.

that are not aimed at providing TAMRA relief. For example, under the proposed protocol, the estate of a Canadian resident who had a small estate may be retroactively eligible for a refund of estate taxes previously paid with respect to assets exempted from U.S. estate tax under paragraph 8.

According to the technical explanation, the negotiators of the treaty believed that, while "it is unusual for the United States to agree to retrospective effective dates," retroactivity was justified in this case "given the fact that the TAMRA provisions were the impetus for negotiation of the Protocol and that the negotiations commenced soon after the enactment of TAMRA." In TAMRA, Congress passed several significant estate and gift tax changes affecting alien individuals. First, the marital deduction generally was disallowed on transfers to non-U.S. citizen spouses. Second, the special tax rates and credits applicable to the estates of nonresident aliens prior to TAMRA were repealed. As discussed previously, several countries other than Canada have sought treaty relief from the changes in TAMRA. Thus, a risk exists that the proposed protocol could be viewed as a precedent by other countries seeking treaty relief from TAMRA and that they could put pressure on the United States to grant them identical concessions.

Retroactive relief under the proposed protocol generally would require reopening of closed estates and tax files closed by the statute of limitations. Other estate tax treaties (e.g., Germany) have provided retroactive relief that has required the reopening of closed estates and tax files. Nevertheless, the Committee may wish to consider whether reopening closed tax and probate matters is desirable.

In light of these issues, the Committee may wish to consider whether it believes that retroactive TAMRA relief under the proposed protocol is warranted. If so, the Committee may wish to clarify that retroactive relief is desirable, in part, because of the special relationship between the United States and Canada and should not necessarily be viewed as a precedent by other countries.

B. Royalties

In general

The proposed protocol would restrict source country taxation of royalties to a greater extent than the existing treaty, although not to the extent provided for in the U.S. model. Compared to the existing treaty, the proposed protocol would expand the categories of royalties that are exempt from source-country taxation, and modify the rule for determining the source of royalty payments.

Scope of exemption

As discussed in Part I above, the existing treaty contains a two-tier (10-percent or exempt) limitation on source-country taxation of royalties. The proposed protocol expands the type of royalties that are eligible for exemption from source country taxation. The expanded category of exempt royalties expressly includes payments for the use of, or the right to use, computer software, patents, and information (unless provided in connection with a rental or fran-

chise agreement) concerning industrial, commercial or scientific experience.

The Internal Revenue Service has issued a private letter ruling holding that no U.S. withholding tax is due on outbound software royalties paid by a U.S. person under the existing treaty.[23] Furthermore, it is the understanding of the staff that, prior to the conclusion of the negotiation of the proposed protocol, the Canadian government issued a ruling that exempted from withholding royalty payments made by a taxpayer with respect to "shrink wrap" software sold under a general license. This result was adopted as policy later in 1994. Thus, the inclusion of software royalties under the exempt category in the proposed protocol may have little practical effect with respect to "shrink wrap" royalties, because they appear to be exempt from Canadian withholding tax under current Canadian law or practice. This result is not the case with respect to other types of software royalties, however.

The proposed protocol would extend the exemption rate on royalties to cover amounts paid for the use of patents and certain know how. Contrary to the U.S. model and the provisions of many U.S. tax treaties with other industrial nations, no similar relief is available for royalties on trademarks, which will continue to be taxed at a 10-percent rate.

The Technical Explanation indicates that in a case where royalties are paid for a bundle of rights in a mixed contract or similar arrangements, some of which, by themselves, would be exempt from source-country taxation, and others would be taxable, exemption would apply to those royalties to the extent that they are paid for the former. This is the first time that the United States explicitly confirms in the Technical Explanation, a requirement of bifurcating a single payment of royalties into a tax-exempt and a taxable portion in a bilateral treaty.[24] Hence, there is no precedent to determine whether the policy may work effectively. Furthermore, staff understand that no additional procedure has been developed to administer the provision. The Comittee may wish to satisfy itself that it will be possible to administer the bifurcation aspect of the provision.

The proposed protocol would permit the treaty countries to agree, through an exchange of diplomatic notes (that is, without any additional treaty ratification procedures), to further expand the exempt category to cover payments with respect to broadcasting. The issue here is whether the Committee is comfortable with the self-executing nature of this provision,[25] notwithstanding the fact that the

[23] Private letter rulings relate to particular taxpayers and are not intended to be used or cited as precedent. In PLR 9128025 (April 12, 1991), the IRS held that payments by a U.S. distributor of computer software to a foreign developer of the software, under a license to reproduce the developer's software in the United States, are exempt from U.S. withholding tax under the applicable treaty. Although the identity of the applicable tax treaty was not revealed in the ruling, the language of the article that the IRS relied on for the applicable treaty is identical to the text of the existing treaty with Canada.

[24] Other U.S. tax treaties provide that different *classes* of royalties are subject to differing rates.

[25] The approach taken in the proposed protocol differs, for example, from the approach taken in the proposed treaty and protocol with Kazakhstan. There, the proposed protocol explicitly refers to a future change to a significant term of the treaty (i.e., a lower rate of withholding tax would be applicable between the United States and Kazakhstan if any lower rate is agreed to in a treaty between Kazakhstan and another OECD country), but the Memorandum of Understanding indicates that such change would be subject to ratification by the United States and by Kazakhstan.

treaty modification authorized to be effective without further ratification procedures would conform the treatment of certain royalties to the preferred U.S. position.

Source rules

Existing treaty

The existing treaty includes a source rule for royalties which sources royalties by place of use, if the place of use is Canada or the United States. Similarly, U.S. internal law sources royalties based on the place of its use (even if the place of use is outside the United States or Canada). For example, if a U.S. resident pays a royalty to a Canadian resident for the right to use intangible property exclusively in Mexico, then under internal U.S. law the Canadian resident has received no U.S. source income, and no U.S. tax under sections 871, 881, 1441, or 1442 applies to the royalty. On the other hand, if the same Canadian resident receives a royalty from a Mexican resident for the right to use intangible property exclusively in the United States, then under both U.S. internal law and the existing U.S.-Canada treaty, the Canadian resident has received *U.S. source* income despite the absence of a payment from a U.S. person.[26] As a result, the Code will impose a U.S. gross-basis tax at the 10-percent rate provided in the existing treaty.[27]

If a Canadian resident pays a royalty to a U.S. resident for the right to use intangible property exclusively in the United States, then under internal U.S. law that royalty generates U.S. source income and does not increase the U.S. resident's foreign tax credit limitation. Under the existing treaty that income generally would not be taxable by Canada. Under the elimination of double taxation article, that income generally would be treated as arising in the United States.

Only where the payment is made by a resident of the United States or Canada, for the right to use the property *outside* the United States or Canada, does the existing treaty source royalties outside the country of use. In that case the existing treaty sources the royalty by reference to the country where the payor resides (or where the payor has a permanent establishment or fixed base, if the royalty was incurred and borne by the permanent establishment or fixed base). And if the rule sourcing the royalty outside the country of use is applicable, then under the elimination of double taxation article, the royalty will only be deemed to arise in a treaty country if the treaty otherwise authorizes taxation of the royalty by that country. For example, if a resident of Canada pays a copyright royalty to a U.S. resident for the right to use a literary work exclusively in the United Kingdom, and neither person has a permanent establishment or fixed base in the country in which the other person resides, then notwithstanding that the royalty may be sourced in Canada under the existing royalty provision, it is not deemed to arise in Canada under the elimination of double taxation article, because Canada generally is precluded by treaty from taxing a literary royalty paid to a U.S. resident.

[26] Under the U.S.-Mexico treaty, such a royalty would be treated as arising from sources in Mexico.

[27] There may be no U.S. withholding agent to collect and pay over the tax, however.

Proposed protocol

The proposed protocol reverses the source rules in the existing treaty. It replaces the source rule in the existing treaty with a provision similar to the corresponding provision in several U.S. treaties, including the U.S. treaties with Australia, New Zealand, and Mexico. In general, the proposed protocol would source a royalty by reference to the country where the payor resides (or where the payor has a permanent establishment or fixed base, if the royalty was incurred and borne by the permanent establishment or fixed base). Only when the payor is *not* a resident of the United States or Canada would royalties be sourced on the basis of the place of use of the property. As a result, then, the general royalty source rule under the proposed protocol (sourced at residence of the payor) differs from the internal U.S.-law rule (sourced at place of use).

For example, if a Canadian resident (who has no permanent establishment in the United States) pays a royalty to a U.S. resident for the right to use intangible property exclusively in the United States, then under internal U.S. law, that royalty generates U.S. source income and does not increase the U.S. resident's foreign tax credit limitation. However, under the proposed protocol, that income could be subject to Canadian tax. If so, then under the elimination of double taxation article, that income would also be treated as arising outside the United States. Staff understand, however, that under current business practices, this situation would arise in relatively few cases (compared to the more common presence of a permanent establishment in the country where the property is used).

The effect of this provision is that certain royalty payments that are treated as U.S. source income under both the existing treaty and under present U.S. internal law would treated, under the proposed protocol, as foreign source income. This change will prevent the United States from imposing withholding tax on some royalties on which U.S. tax may currently be imposed (as in the above example, where a resident of Canada with no permanent establishment in the United States pays royalties to a resident of the United States, for the use of property in the United States). In addition, treating such royalty income as foreign source income can enhance a U.S. taxpayer's foreign tax credit limitation. A U.S. taxpayer that has excess foreign tax credits may offset the U.S. tax imposed on such income, causing further erosion of the U.S. tax base.[28]

Under Article XXIX of the existing treaty (Miscellaneous Rules), a Canadian resident may elect to be taxed under the U.S. internal rules to determine the source of the income, to the extent it is favorable. Such an election may be made by a Canadian resident who receives a royalty for the use of property outside the United States that is paid by a U.S. person. Staff understand, however, that under current business practices, this situation would arise in relatively few cases (compared to the currently more common situation in which a U.S. resident receives a royalty for the use of property outside the United States that is paid by a Canadian person).

[28] While the proposed protocol would permit the United States to impose tax in the reverse situation (where a resident of the United States pays royalties to a resident of Canada for the use of property in Canada), no U.S. withholding tax would actually be imposed under internal U.S. law.

Furthermore, the fact that the proposed protocol changes the source of the royalty payments could enable a third-country resident to use the unusual royalty source rules of the proposed protocol to avoid U.S. tax. This may be accomplished, for example, by structuring a license through a Canadian company that qualifies for derivative benefits under the proposed protocol, as discussed below. Because the source rules in the proposed protocol differ from most other U.S. treaties, taxpayers may seek to take advantage of the inconsistencies among U.S. treaties in structuring licensing arrangements.[29] The Committee may wish to consider whether such inconsistencies in the source rules are advisable.

C. Limitation on Benefits

In general

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Canada as they apply to residents of the two countries. At times, a person who is not a resident of either country seeks certain benefits under the income tax treaty between the two countries (referred to as "treaty shopping"). Under certain circumstances, and without appropriate safeguards, the nonresident is able indirectly to secure these benefits by establishing a corporation (or other entity) in one of the countries. Such an entity, as a resident of that country, would be entitled to the benefits of the treaty without such safeguards. Additionally, it may be possible for the third-country resident to reduce the income tax base of the treaty-country resident by having the latter pay out interest, royalties, or other amounts under favorable conditions (i.e., it may be possible to reduce or eliminate taxes of the resident company by distributing its earnings through deductible payments or by avoiding withholding taxes on the distributions) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

The proposed protocol contains a limitation on benefits, or "anti-treaty shopping" article that permits the United States to deny treaty benefits to a resident of Canada unless requirements, similar in many respects to those contained in recent U.S. treaties and in the branch tax provisions of the Code, are met. This provision replaces very limited anti-abuse provisions restricting benefits under the existing treaty. Nevertheless, there are significant differences between the provisions of the proposed protocol and the corresponding provisions of other U.S. treaties and internal U.S. law. Such differences include:

- The lack of a base-erosion rule in the test relating to subsidiaries of publicly traded companies, to limit potentially abusive structures.
- The testing of aggregate vote and value in the ownership and base-erosion test without any appropriate anti-abuse provisions (e.g., a rule to prohibit the issuance of shares that achieve disproportionate allocation of rights).

[29] See also the discussion of the derivative benefits rule in Part II. C. of this pamphlet, below (relating to Limitation on Benefits).

• The ability to satisfy the active-business test if a person related to the entity claiming treaty benefits is conducting the active business. As in some other U.S. treaties, it is unclear to what extent such rule may open the active-business test to potential abuse.

• The derivative benefits rule, which extends benefits of the proposed protocol to a Canadian company that is wholly owned by third-country residents, even though the ultimate owners may not obtain the identical benefits under the treaty between their country of residence and the United States.

Unlike most other corresponding U.S. treaty provisions, the proposed anti-treaty-shopping article does not affirmatively provide Canada any basis on which to deny any treaty benefits. It does, however, include an explicit understanding, not found in any other U.S. treaty, as to the noninterference of the treaty with application by each country of its internal anti-abuse rules. Such a rule permits Canada to unilaterally change its standards in implementing the anti-avoidance provisions. Thus, a U.S. person could face uncertainty in determining its ability to claim benefits under the proposed protocol.[30]

It may be argued that treaty shopping through the United States is unlikely given its generally relatively high rates. Further, it could be argued that no U.S. policy is impaired if a treaty partner (Canada in this case) does not wish to establish reciprocal limitation on benefit rules. Nevertheless, the fact that the anti-treaty-shopping provisions of the proposed protocol are looser than, or differ from, comparable provisions in other U.S. tax treaties could create an unintended disincentive to third countries to enter into bilateral tax treaties with the United States that include tighter provisions relating to limitations on benefits.

Under the proposed new anti-treaty-shopping article, a resident of Canada is not entitled to the benefits of the treaty from the United States unless it is a so-called "qualifying person," or satisfies an active business test, a derivative benefits test, or the U.S. competent authority otherwise grants treaty benefits based on criteria set forth below.

Qualifying person

A qualifying person must be a Canadian resident. Having satisfied that criterion, an individual or an estate will be a qualifying person. The term qualifying person also includes a company or trust that satisfies an ownership and "base erosion" test. The term includes a company or trust that satisfies an exchange-traded test, and a company that is closely held by exchange-traded companies or trusts. Also qualifying are Canadian governmental entities and instrumentalities, as well as certain not-for-profit or employee benefits organizations.

Exchange-traded company or trust or its subsidiary

Under the exchange-traded test, a company or trust that is a resident of Canada is a qualifying person if there is substantial and regular trading in its principal class of shares or units on a recog-

[30] The Technical Explanation suggests that this concept is implicit in all tax treaties. It could therefore be argued that uncertainty resulting from changes in internal law could arise under any tax treaty.

nized stock exchange. The term "recognized stock exchange" includes the NASDAQ System owned by the National Association of Securities Dealers, Inc. in the United States; any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934; any Canadian stock exchange that is a "prescribed stock exchange" under the Income Tax Act; and any other stock exchange agreed upon by the two countries in an exchange of notes, or by the competent authorities of the two countries. At the time the proposed protocol was signed, "prescribed stock exchanges" were the Alberta, Montreal, Toronto, Vancouver, and Winnipeg Stock Exchanges.

In order for a company to satisfy the test for being closely held by exchange-traded companies or trusts, more than 50 percent of the vote and value of the company's shares (other than debt substitute shares) must be owned, directly or indirectly, by five or fewer persons each of which is a company or trust that is exchange traded as provided above, provided that each company or trust in the chain of ownership is either a qualifying person, or a U.S. resident or citizen. The term "debt substitute share" refers to certain shares issued in exchange or substitution for debt in certain cases of financial difficulty, as described in section 248(1)(e) of the Canadian Income Tax Act (part of the definition of the term "term preferred share"). The term also refers to such other type of share as may be agreed upon by the competent authorities of the treaty countries.

This rule for subsidiaries of exchange-traded companies is similar to a provision in the U.S.-Netherlands treaty, but omits certain provisions that can be regarded as attempts to prevent abuse. Like the U.S. branch tax rules, the Netherlands treaty allows benefits to be afforded to the wholly owned subsidiary of a publicly traded company. Unlike any other existing treaty, but like the proposed protocol, the Netherlands treaty provides that benefits must be afforded to certain joint ventures of publicly traded companies. However, the Netherlands treaty requires that if benefits are to be afforded a company resident in a treaty country on the basis of public trading in the stock of the company's shareholder or shareholders, then the company seeking treaty benefits must also meet one of two additional tests that measure base erosion. That is, the company either must not be a "conduit company" or, if it *is* a conduit company, the company must meet a "conduit company base-reduction test."[31] There are no additional tests that measure base erosion that apply to a Canadian company that seeks treaty benefits on the basis of ownership by exchange-traded companies. A comparable provision exists under the branch profits tax provision of the U.S. internal law. Under that provision, only a wholly-owned subsidiary of a publicly traded corporation that is organized under the laws of the same country may be treated as a "qualified resi-

[31] Under the Netherlands treaty, a conduit company is one that pays out currently at least 90 percent of its aggregate receipts that are deductible payments (including royalties and interest, but excluding those at arm's length for tangible property in the ordinary course of business or services performed in the payor's residence country). A conduit company meets the conduit base-reduction test if less than a threshold fraction (generally 50 percent) of its gross income is paid to associated enterprises subject to a particularly low tax rate (relative to the tax rate normally applicable in the payor's residence country).

dent" of its country of residence. Consequently, this provision of the proposed protocol is less stringent than U.S. tax policy in this area under both our internal law and existing treaty practices. The Committee should satisfy itself that the potential for abuse of the treaty through application of this provision is sufficiently limited as not to be a concern.

Ownership and base-erosion test

A company satisfies the ownership requirement of the ownership and base-erosion test if 50 percent or more of the vote and value of the shares (other than debt substitute shares) are not owned, directly or indirectly, by persons other than qualifying persons, or U.S. residents or citizens. A trust satisfies the ownership and base-erosion test if 50 percent or more of the beneficial interest in the trust is not owned, directly or indirectly, by persons other than qualifying persons, or U.S. residents or citizens. This rule could, for example, result in denial of benefits of the reduced U.S. withholding tax rates on dividends or royalties paid to a Canadian company that is controlled by individual residents of a third country.

This ownership requirement is not as strict as that contained in the anti-treaty-shopping provision proposed at the time that the last U.S. model income tax treaty was proposed, which required 75-percent ownership by residents of the person's country of residence, in order to preserve benefits. On the other hand, it is in some ways similar to provisions in recently negotiated treaties. It differs from other treaties, however, in at least two respects.

First, like the U.S.-Netherlands treaty (and unlike most other U.S. treaties), a Canadian entity determines whether the ownership requirement is met, in part, by reference to whether the owners of that entity are *themselves* entities that have met the ownership and base-erosion test. However, in contrast to the corresponding provision in the Netherlands treaty (Article 26(1)(d)(i)), the relevant portion of the proposed Canadian protocol is worded in the negative. An effect of the wording of this provision in the negative is that intervening tiers of companies are also treated as qualifying persons, or not, by reference to the ultimate beneficial owners. This aspect of the proposed protocol is similar to the proposed treaty with France but differs from other U.S. tax treaties including the proposed treaty with Portugal and the existing treaty with the Netherlands.

A second difference between the ownership requirement in the proposed protocol and the ownership requirements in other recent treaties concerns the application of the vote and value tests to multiple classes of shares. In order for an entity to meet the corresponding provisions in some treaties, such as the U.S.-Germany treaty, appropriate persons must own 50 percent of *each class* of the entity's shares. Under other treaties, such as the U.S.-Israel treaty (as modified by its second protocol) and the U.S. Netherlands treaty, the corresponding provision is applied by reference to the aggregate votes and values represented by all classes of shares (as is true in the proposed protocol), but anti-abuse provisions are inserted to prevent avoidance of the requirements by issuing classes of shares bearing rights that achieve disproportionate allocations among taxpayers. The proposed protocol omits any similar anti-

abuse provisions. Thus, in contrast to a case arising under another treaty, in a case arising under the proposed protocol such abuses must be addressed by the IRS, if at all, by exercising its authority provided outside the treaty, and recognized in paragraph 7 of the limitation on benefits article.

A company or trust that meets the foregoing ownership requirements must also meet a base-erosion requirement in order to satisfy the ownership and base-erosion test. This requirement is met only if the amount of the expenses deductible from gross income that are paid or payable by the company or trust for its preceding fiscal period (or, in the case of its first fiscal period, that period) to persons that are not qualifying persons, or U.S. residents or citizens, is less than 50 percent of its gross income for that period. This rule is of a type commonly referred to as a "base erosion" rule and is necessary to prevent a corporation, for example, from distributing (including paying, in the form of deductible items such as interest, royalties, service fees, or other amounts) most of its income to persons not entitled to benefits under the treaty. However, the operation of this rule might raise administrative difficulties if payments are made, for example, from one Canadian person to another Canadian person that is not a qualifying person. The payor in this case would have to know that the payee is in fact a qualifying person in order to obtain the favorable rate under the protocol. While this circumstance may be relatively rare, the Committee may wish to express its views on the consideration of such concerns in designing anti-treaty-shopping tests.

Active-business test

Under the active-business test, treaty benefits with respect to certain income would be available to a Canadian resident that is not a qualifying person, if that Canadian resident, or a person related to that Canadian resident, is engaged in the active conduct of certain types of trades or businesses in Canada. A trade or business for this purpose means any trade or business other than the business of making or managing investments, unless carried on with customers in the ordinary course of business by a bank, an insurance company, a registered securities dealer or a deposit-taking financial institution. In this case, benefits would be provided with respect only to income derived from the United States in connection with or incidental to that trade or business, including any such income derived directly or indirectly by that resident person through one or more other persons that are residents of the United States. Under the proposed protocol, income will be deemed to be derived from the United States in connection with the active conduct of a trade or business in Canada only if that trade or business is substantial in relation to the activity carried on in the United States giving rise to the income in respect of which U.S. treaty benefits are claimed.

This provision corresponds to provisions found in other recent U.S. treaties, although it is not identical to any of them. For example, where the proposed protocol provides treaty benefits if the active trade or business in connection with which the income is earned is carried on by a related person, or received indirectly through a related person, the Netherlands treaty provides a more

elaborate set of attribution rules, and the German treaty is interpreted in a memorandum of understanding to operate under similar principles.[32]

The Technical Explanation indicates that for purposes of the active business test under the proposed protocol, a related person has the same meaning as under Internal Revenue Code section 482, which permits the Internal Revenue Service to reallocate items between two or more organizations, trades, or business that are owned or controlled directly or indirectly by the same interests. This definition of related party generally depends on all the facts and circumstances, and does not provide a bright-line test ensuring certainty to taxpayers that a more mechanically applied attribution rule provides.

Derivative benefits rule

The limitation on benefits article in the proposed protocol includes a "derivative benefits" provision corresponding to those found in only a limited number of other limitation on benefit articles (contained in the U.S. treaties with the Netherlands, Mexico, and Jamaica, and the proposed treaty with France), under which a Canadian company is entitled to reduced U.S. tax on dividends, interest, and royalties based on the eligibility of its stockholders, who may be residents of a third country, for treaty relief at least as favorable under a treaty between the United States and the third country. It should be noted that this provision reflects a significant departure from the derivative benefits article contained in almost all other U.S. tax treaties in that it does not require *any* same-country ownership of the Canadian corporation claiming the relevant treaty benefits.[33] In other words, a Canadian entity that is 100-percent owned by third-country residents and that does not otherwise have a nexus with Canada, e.g., by engaging in an active trade or business there, may be entitled to claim certain benefits under the proposed protocol.

Under this provision, a Canadian resident company would be entitled to the benefits of Articles X (Dividends), XI (Interest) and XII (Royalties) if it satisfies an ownership requirement and a base-erosion requirement. The base-erosion requirement matches the corresponding requirement under the ownership and base-erosion test for status as a "qualifying person." To satisfy the ownership requirement, however, a different test is used. Under the derivative benefits rule, shares that represent more than 90 percent of the aggregate vote and value represented by all of its shares (other than debt substitute shares) must be owned, directly or indirectly, by

[32] For example, under the limitation on benefits provision of the U.S. treaty with the Netherlands, the committee report provides, "the active business test takes into account the extent to which the person seeking treaty benefits either is itself engaged in business, or is deemed to be so engaged through the activities of related persons. . . . Attribution for this purpose, although generally not set forth in the literal language of the active business test language in other recent treaties, has been used under those treaties." *Report of the Senate Committee on Foreign Relations on the 1992 U.S.-Netherlands Income Tax Treaty and 1993 Protocol*, Sen. Exec. Rept. 103-19, 103d Cong., 1st Sess. at 117 (1993). See also *Understandings Regarding the Scope of the Limitation on Benefits Article in the Convention between the Federal Republic of German and the United States of America*, Example II.

[33] Article 26(1)(c)(iii) of the U.S.-Netherlands tax treaty, for example, requires 30 percent Dutch ownership of the entity claiming derivative benefits. The other 70 percent of the company must be owned by residents of the United States or of members of the European Community.

persons each of whom is a qualifying person, a U.S. resident or citizen or a person who meets each of three conditions.

First, the person must be a resident of a country with which the United States has a comprehensive income tax treaty, and must be entitled to all of the benefits provided by the United States under that treaty. The effectiveness of this requirement in limiting treaty-shopping opportunities could be questioned in cases where U.S. treaty with the third country of which the person is a resident does not itself contain a limitation on benefits provision (which are contained in fewer than half of U.S. bilateral income tax treaties), or provides less restrictive rules. The precedential value of this rule should not be overlooked. If the United States permits residents of third countries to claim benefits of one of its treaties, it should only permit such derivative benefits in cases where the benefits that a third-country resident could claim, under its own treaty with the United States, are no more favorable than the ones that are available under a derivative benefits article, in order to avoid potential abuses.

Second, the person must be one either who would be a "qualifying person" under the proposed protocol if the person were a resident of Canada, or who could satisfy an active business test. To satisfy the active business test, the person must be one who would qualify for benefits under the proposed protocol's active business test, if that person were a resident of Canada and the business it carried on in the country of which it is a resident were carried on by it in Canada. The active-business test qualifies a person for benefits only with respect to certain income: that is, income derived in connection with or incidental to that business. The Technical Explanation clarifies that the income that is relevant for purposes of qualification under this test is the same income with respect to which treaty benefits would be available by satisfying the requirements of the provision (that is, income that is eligible for the reduced rate: interest, dividends or royalties). In addition, it is understood that it would be permissible under the proposed protocol for the United States to deny treaty benefits to any particular portion of the income of the Canadian resident on the ground that portion represents income *not* derived in connection with or incidental to the appropriate business.

In defining "qualifying person" for this purpose, the language of the proposed protocol differs from the comparable provision of the Netherlands treaty.[34] The determination of whether a person is a resident of Canada for this purpose should be made as if the third country were Canada. The Technical Explanation clarifies that the provision is intended to apply in this manner.

Third, under the treaty between that person's country of residence and the United States, the person must be entitled to a limitation on the rate of U.S. tax on the particular class of income for which benefits are being claimed under the Canadian treaty, that

[34] See Article 26(8)(i) of the U.S.-Netherlands tax treaty which provides, "The term 'resident of a member state of the European Communities' means a person that would be considered a resident of any such member state under the principles of Article 4 (Resident) and would be entitled to the benefits of this Convention under the principles of paragraph 1, *applied as if such member state were the Netherlands* . . ." (emphasis supplied).

is at least as low as the rate applicable under the Canadian treaty.[35]

Grant of benefits by the competent authority

Finally, like other treaties, the proposed protocol provides a "safety-valve," under which benefits may be provided to a treaty-country resident that has not established that it meets one of the other more objective tests. In other treaties, particularly in newer treaties and the branch profits tax provisions of the Code, such provisions typically provide the competent authority with discretion to grant treaty benefits. In addition, they sometimes set forth guidelines in greater or lesser detail for the competent authority's exercise of that discretion.

The proposed protocol provides that where a resident of Canada is not entitled under the preceding provisions of the limitation on benefits article to U.S. treaty benefits, the U.S. competent authority shall, upon that person's request, determine whether one of two conditions apply. The determination is to be made on the basis of all factors including the history, structure, ownership and operations of that person. If the competent authority determines that either condition applies, then the person is to be granted the benefits of the treaty.

The first condition is that the person's creation and existence did not have as a principal purpose the obtaining of benefits under the treaty that would not otherwise be available. The second condition is that it would not be appropriate, having regard to the purpose of the limitation on benefits article, to deny the benefits of the treaty to that person. The Technical Explanation does not clarify the circumstances under which treaty benefits would be granted by the competent authority under the second condition.

There appears to be no comparable provision with precisely identical language in this respect. Some earlier treaties, such as those with Australia and New Zealand, require treaty benefits to be provided if the establishment, acquisition, and maintenance of the person, and the conduct of its operations did not have as one of its principal purposes the purpose of obtaining benefits under the treaty.

The language of the proposed protocol differs from that in the German treaty in that the proposed protocol may require a factor that might otherwise merely be taken into consideration to be dispositive. Thus, the competent authorities may not have adequate authority to deny benefits, under the language of the proposed protocol. That is, if the competent authority does determine that the person's creation and existence did not have as a principal purpose the obtaining of benefits under the treaty that would not otherwise be available, then the competent authority must grant treaty benefits. The committee should satisfy itself that the provision permitting the grant of treaty benefits by the competent authority is not so limiting as to permit the competent authorities adequate discretion to deny benefits in appropriate circumstances as well.

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[35] See the discussion in Section B, above, relating to royalties, for an issue raised by using solely the rate as the benchmark for the third requirement.

Anti-abuse rules

The proposed protocol includes a provision, not found in any other treaty, that either of the Contracting States may deny treaty benefits "where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Convention." Under this provision, either Canada or the United States may apply internal law to deny treaty benefits. This is the only limitation on the provision of treaty benefits by Canada, whereas it supplements all of the foregoing rules for limitation on treaty benefits by the United States. The Technical Explanation states that Canada will remain free to apply its internal anti-avoidance rules to counter abusive arrangements involving treaty-shopping through the United States, and the United States will remain free to apply its substance-over-form and anticonduit rules, for example, in relation to Canadian residents.

Internal U.S. law

U.S. courts have stated that the incidence of taxation depends upon the substance of a transaction as a whole.[36] In certain cases, courts have recharacterized transactions in order to impose tax consistent with this principle. For example, where three parties have engaged in a chain of transactions, the courts have at times ignored the "middle" party as a mere "conduit," and imposed tax as if a single transaction had been carried out between the parties at the ends of the chain.

In *Aiken Industries, Inc. v. Commissioner*,[37] the Tax Court recharacterized an interest payment by a U.S. person on its note held by a related treaty-country resident, which in turn had a precisely matching obligation to a related non-treaty-country resident, as a payment directly by the U.S. person to the non-treaty-country resident. The transaction in its recharacterized form resulted in a loss of the treaty protection that would otherwise have applied on the payment of interest by the U.S. person to the treaty-country resident, and thus caused the interest payment to give rise to 30-percent U.S. tax.

The IRS has taken the position that it will apply a similar result in cases where the back-to-back related party debt obligations are less closely matched than those in *Aiken Industries*, so long as the intermediary entity does not obtain complete dominion and control over the interest payments.[38] The IRS has taken an analogous position where an unrelated financial intermediary is interposed between the two related parties as lender to one and borrower from the other, as long as the intermediary would not have made or maintained the loan on the same terms without the corresponding borrowing.[39] In a technical advice memorandum, the IRS has taken the position that interest payments by a U.S. company to a related, treaty-protected financial intermediary may be treated as payments by the U.S. company directly to the foreign parent of the financial intermediary even though the matching payments from the

[36] See, e.g., *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).
[37] 56 T.C. 925 (1971), *acq. on another issue*, 1972–2 C.B. 1.
[38] Rev. Rul. 84–152, 1984–2 C.B. 381; Rev. Rul. 84–153, 1984–2 C.B. 383.
[39] Rev. Rul. 87–89, 1987–2 C.B. 195.

intermediary to the parent are not interest payments, but rather are dividends.[40]

A provision of the Code enacted in 1993 expressly authorizes the Treasury Secretary to promulgate regulations that set forth rules for recharacterizing any multiple-party financing transaction as a transaction directly among any two or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by the Internal Revenue Code.[41] The Code authorizes regulations that apply not solely to back-to-back loan transactions, but also to other financing transactions. For example, it would be within the proper scope of the provision for the Secretary to issue regulations dealing with multiple-party transactions involving debt guarantees or equity investments.

Proposed Treasury regulations under this provision establish a standard for treating an intermediate entity as a conduit. If the intermediate entity is related to the financing entity or the financed entity, the financing arrangement generally will be subject to recharacterization if (i) the participation of the intermediate entity in the financing arrangement reduces U.S. withholding tax, and (ii) the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan. If the intermediate entity is unrelated to both the financing entity and the financed entity, the financing arrangement generally will be subject to recharacterization if the two conditions described above are satisfied and, in addition, the intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity. The proposed regulations are intended to provide anti-abuse rules that supplement, but do not conflict with, the limitation on benefits articles in U.S. income tax treaties. To date, the Secretary has not promulgated final regulations under this provision.

Internal Canadian law

A general anti-avoidance rule enacted in 1988 provides that where a transaction is an avoidance transaction, the tax consequences shall be determined as is reasonable under the circumstances in order to deny a tax benefit that would otherwise result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.[42] The term "avoidance transaction" refers to a transaction other than one that may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.[43] Tax benefits are not to be denied where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of the Income Tax Act or an abuse having regard to the provisions of that Act (other than the general anti-avoidance rule), read as a whole.[44] The terms "tax benefit" and

[40] Tech. Adv. Mem. 9133004 (May 3, 1991).
[41] Code section 7701(*l*).
[42] Income Tax Act sec. 245(2).
[43] Income Tax Act sec. 245(3).
[44] Income Tax Act sec. 245(4).

"tax consequences" also refer only to taxes and related concepts as they are relevant under the Income Tax Act. Thus, for example, they may not include treaty relief from taxes imposed under the Income Tax Act.

Issues raised by the provision

Issues raised by this "anti-abuse" provision include opacity, one-sidedness, and lack of conformity to other tax treaties.

The provision could be considered as opaque and, therefore as not providing taxpayers with adequate guidance or certainty, in that it relies only on internal Canadian law to determine whether a person, otherwise treated as a resident of the United States under Article IV of the treaty, is not entitled to treaty benefits in Canada due to "abuse" of the treaty provisions. Legislative or judicial developments could change the substance of Canadian tax law as to what constitutes such an abuse. For example, a new general income tax anti-avoidance rule was enacted in Canada in 1988 which considerably changed the notion of abuse and which may be the subject of further interpretation or change.[45] Canadian law might be interpreted more strictly in the future than at present, precluding hitherto qualifying U.S. residents from treaty benefits. As a result, relying exclusively on internal Canadian law to prevent treaty shopping through the United States may create uncertainty from one year to the next for U.S. residents that would otherwise be eligible for treaty benefits.[46] The Technical Explanation suggests that the application of internal anti-abuse rules is implicit in bilateral tax treaties. The fact that such internal rules are the only operative anti-treaty-shopping rules applicable to U.S. residents under the proposed protocol magnifies the importance of the lack of certainty presented by such rules.

On the other hand, internal rules apply in determining treaty-country residents' tax liability, and the fact that such rules may change do not necessarily make for a weakness in the treaty provisions. This issue is addressed in the commentary to the OECD model treaty published by the Committee on Fiscal Affairs of the OECD. The commentary to Article 1 of the OECD model treaty states that the purpose of tax treaties is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons; and that tax treaties should not help tax avoidance or evasion. The OECD model treaty contains no anti-abuse provisions, but the commentary discusses the types of provisions that treaty negotiators might wish to consider. In addition, the commentary mentions internal law measures that provide possible ways to deal with abuse of tax treaties, such as "substance-over-form" rules. The commentary indicates a difference of views among representatives of the member countries on the Committee of Fiscal Affairs whether or not general principles such as "substance-over-form" are inherent in treaty provisions, i.e., whether they can be applied in any case, or only to the extent they

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[45] See Arnold, Brian J. and James R. Wilson, "The General Anti-Avoidance Rule" (a 3-part article), 36 *Can. Tax J.* 829 (Jul.-Aug. 1988) (part I); 36 *Can. Tax J.* 1123 (Sep.-Oct. 1988) (part 2); and 36 *Can. Tax J.* 1369 (Nov.-Dec. 1988) (part 3).

[46] The same type of uncertainty could arise for residents of Canada as a result of legislative or judicial changes in what constitutes treaty abuse under U.S. internal law.

are expressly mentioned in treaties. The commentary states that it is the view of the wide majority of OECD member countries that such rules, and the underlying principles, do not have to be confirmed in the text of the treaty to be applicable. Where these rules are not addressed in tax treaties, the commentary indicates a majority view that these rules are not affected by the treaties. The commentary also indicates that internal law measures designed to counteract abuses should not be applied to countries in which taxation is comparable to that of the country of residence of the taxpayer.

Consistent with the majority view expressed in the OECD commentary, the Technical Explanation of the proposed protocol states that the two countries have agreed that the principle that each treaty country's internal anti-abuse rules apply in interpreting the proposed protocol is inherent in the existing treaty. Further, the Technical Explanation states that the absence of similar language in other treaties is not intended to suggest that the principle it expresses is not also inherent in other tax treaties.

The anti-abuse rule (unlike the rest of the limitation on benefits provision of the proposed protocol) is reciprocal. As a practical matter, however, because of the detailed limitation on benefit rules that apply only in the case of Canadian residents and the fact that U.S. internal-law anti-abuse rules may reach more broadly than Canada's,[47] the provision could be considered somewhat one-sided. While the provisions limiting treaty-shopping through Canada protect the U.S. interest in preventing base erosion, the Technical Explanation indicates that Canada itself prefers not to utilize such rules to prevent treaty shopping through its treaty partners.

An issue of conformity arises because this part of the anti-treaty-shopping provision is unique among U.S. income tax treaties. Absent conformity, U.S. residents may not be consistently ensured treaty benefits in countries with which the United States has tax treaties. On the other hand, potential treaty partners may view this provision as an indication that the United States is willing to tailor anti-treaty-shopping provisions as appropriate to the particular circumstances of each treaty partner. The Committee should satisfy itself that the provision as proposed does not serve as a precedent that might interfere in the efforts of the United States to maintain a network of anti-treaty-shopping provisions that adequately protects the U.S. tax base as well as the interests of residents of the United States.

D. Deductibility of Gambling Losses

A nonresident alien individual or foreign corporation generally is subject to U.S. tax on gross U.S. source gambling winnings, collected by withholding. In general, no offsets or refunds are allowed for gambling losses (*Barba v. United States*, 2 Cl. Ct. 674 (1983)). On the other hand, a U.S. citizen, resident, or corporation may be entitled to deduct gambling losses to the extent of gambling winnings (sec. 165(d)). Staff understand that Canada does not have a provision comparable to section 165(d). Instead, an individual may be subject to tax on income derived from gambling only if the

[47] See, e.g., Arnold and Wilson, *supra*, at 872, 880–882.

gambling activities constitute carrying on a trade or business (e.g., the activities of a bookmaker). Whether gambling activities rise to the level of a trade or business is determined on the facts and circumstances of each case.

The proposed protocol adds a provision not found in any other U.S. treaty or the model treaties, permitting a resident of either country the benefit of certain gambling losses against taxes paid to the other country. As applied to a Canadian resident with U.S. tax liability, the Technical Explanation indicates that the protocol requires the United States to allow a Canadian resident to file a refund claim for U.S. tax withheld, to the extent that the tax would be reduced by deductions for U.S. gambling losses the Canadian resident incurred under the deduction rules that apply to U.S. residents. This provision has the practical effect of permitting a refund only of U.S. taxes imposed on U.S. gambling winnings, while not changing the Canadian tax treatment of Canadian gambling winnings (which are generally exempt from Canadian tax for a person not engaged in the trade or business of gambling).[48]

For example, assume that in 1996, a Canadian resident individual has, before reduction for any U.S. taxes withheld, $5,000 of U.S. source gambling winnings, $5,000 of non-U.S. source gambling winnings, $10,000 of U.S. source portfolio dividends, and $7,500 of losses from gambling. All of his losses were at wagers that, had he won, would have generated U.S. source income. At the end of the year he has borne $3,000 U.S. tax by withholding, $1,500 of which was imposed on his U.S. source gambling winnings. It is understood that the proposed protocol would authorize a refund of no more than $1,500 of U.S. tax.

It is understood that the provision would not permit a Canadian resident who is not engaged in the trade or business of gambling, and who has Canadian gambling losses and U.S. gambling winnings, to offset the losses and winnings against each other for U.S. tax purposes. For example, assume that in 1996, a Canadian resident individual has, before reduction for any U.S. taxes withheld, $15,000 of U.S. source gambling winnings and $8,000 of gambling losses from wagers that, had he won, would have generated Canadian source winnings. At the end of the year he has borne $3,000 U.S. tax by withholding, none of which may be refunded under this provision of the proposed protocol.

Notwithstanding the language of the proposed protocol to provide a reciprocal benefit to U.S. persons (a U.S. person would be entitled to a deduction for Canadian tax purposes for Canadian gambling losses), the provision is, as a practical matter, non-reciprocal. A U.S. person who is not a professional gambler is exempt from Canadian income tax on his winnings under Canadian law. Under Articles V and VII of the existing treaty, a U.S. resident who is a professional gambler presumably would be subject to Canadian income tax on his winnings only if he has a permanent establishment in Canada. In the latter case, the U.S. resident would already be entitled to deduct his gambling losses against his gambling winnings under Article VII (Business Profits). As a result, this provision

[48] The "other income" provision of most U.S. tax treaties permits taxation of income not addressed elsewhere in the treaty (such as gambling winnings) only in the country in which it arises.

could be described as reflecting a one-sided concession by the United States.

E. Relationship to Uruguay Round Trade Agreements (Preemption of GATS)

The multilateral trade agreements encompassed in the Uruguay Round Final Act, which entered into force as of January 1, 1995, include a General Agreement on Trade in Services ("GATS"). This agreement generally obligates members (such as the United States and Canada) and their political subdivisions to afford persons resident in member countries (and related persons) "national treatment" and "most-favored-nation treatment" in certain cases relating to services. The GATS applies to "measures" affecting trade in services. A "measure" includes any law, regulation, rule, procedure, decision, administrative action, or any other form. Therefore, the obligations of the GATS extend to any type of measure, including taxation measures.

However, the application of the GATS to tax measures is limited by certain exceptions under Article XIV and Article XXII(3). Article XIV requires that a tax measure not be applied in a manner that would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services. Article XIV(d) allows exceptions to the national treatment otherwise required by the GATS, provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other members. "Direct taxes" under the GATS comprise all taxes on income or capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of wages or salaries paid by enterprises as well as taxes on capital appreciation.

Article XXII(3) provides that a member may not invoke the GATS national treatment provisions with respect to a measure of another member that falls within the scope of an international agreement between them relating to the avoidance of double taxation. In case of disagreement between members as to whether a measure falls within the scope of such an agreement between them, either member may bring this matter before the Council for Trade in Services. The Council is to refer the matter to arbitration; the decision of the arbitrator is final and binding on the members. However, with respect to agreements on the avoidance of double taxation that are in force on January 1, 1995, such a matter may be brought before the Council for Trade in Services only with the consent of both parties to the tax agreement.

Article XIV(e) allows exceptions to the most-favored-nation treatment otherwise required by the GATS, provided that the difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which the member is bound.

Staff understand that both Canada and the United States agree that, in the case of a treaty that is treated as in force on January 1, 1995, as discussed above, a protocol to that treaty also is treated as in force on January 1, 1995 for purposes of the GATS. Neverthe-

less, inasmuch as the proposed protocol extends the application of the existing treaty, and particularly the nondiscrimination article, to additional taxes (e.g., some non-income taxes imposed by Canada), staff understand that the negotiators sought to remove any ambiguity and agreed to a provision that clarifies the scope of the treaty and the relationship between the treaty and GATS.

Thus, the proposed protocol specifies that for this purpose, a measure would fall within the scope of the existing treaty (as modified by the proposed protocol) if it related to any tax imposed by Canada or the United States, or to any other tax to which any part of the treaty applies (e.g., a state, provincial, or local tax), but only to the extent that the measure relates to a matter dealt with in the treaty. Moreover, any doubt about the interpretation of this scope is to be resolved between the competent authorities as in any other case of difficulty or doubt arising as to the interpretation or application of the treaty, or under any other procedures agreed to by the two countries.

This provision of the proposed protocol is drafted more narrowly than the corresponding provisions of the proposed treaties with France, Portugal, and Sweden. Staff understand that the difference results solely from an effort not to interfere with the operation of the North American Free Trade Agreement ("NAFTA"), and that the corresponding provisions of the proposed treaties with France, Portugal, and Sweden reflect the preferred position of the U.S. Treasury Department.

Inasmuch as this provision of the proposed protocol (and the corresponding provisions of other proposed treaties) is unprecedented, the Committee may wish to satisfy itself that the provisions of the proposed protocol are adequate to preclude the preemption of the mutual agreement provisions of the proposed protocol by the dispute settlement procedures under the GATS.

F. Assistance in Collection

The proposed protocol adds a new article to the treaty requiring each country to undertake to lend administrative assistance to the other in collecting taxes covered by the treaty. The assistance provision is substantially broader than the most nearly comparable provision in the U.S. model treaty or the existing treaty.[49]

The proposed protocol provides that the countries are to undertake to lend assistance to each other in collecting all categories of taxes collected by or on behalf of the government of each country, together with interest, costs, additions to such taxes and civil penalties. No assistance, however, is to be provided under this article for a revenue claim with respect to an individual taxpayer to the extent that the taxpayer can demonstrate that the claim relates to a taxable period in which the taxpayer was a citizen of country from which assistance is requested (the "requested country"). Similarly where the taxpayer is a company, estate, or trust, no assistance is to be provided under this article for a revenue claim to the

[49] Under the existing treaty, similar to the U.S. model treaty and other U.S. treaties, each country will endeavor to collect on behalf of the other country such amounts as may be necessary to ensure that relief granted by the treaty from taxation imposed by that other country does not enure to the benefit of persons not entitled thereto (Article XXVI(4) (Mutual Agreement Procedure). The proposed protocol does not alter this provision.

extent that the taxpayer can demonstrate that the claim relates to a taxable period in which the taxpayer derived its status as such an entity from the laws in force in the requested country. The only collection assistance in such a case would be assistance authorized under the existing treaty's mutual agreement procedure article.

When one country applies to the other for assistance in enforcing a revenue claim, its application must include a certification that the taxes have been finally determined under its own laws. For purposes of this article, a revenue claim is finally determined when the applicant country has the right under its internal law to collect the revenue claim and all administrative and judicial rights of the taxpayer to restrain collection in the applicant country have lapsed or been exhausted.

The proposed protocol specifies that each country may accept for collection a revenue claim of the other country which has been finally determined. Consistent with this language, The Technical Explanation states that each country has the discretion whether to accept any particular application for collection assistance. If the request is accepted, generally the accepting country is to collect the revenue claim as though it were its own revenue claim, finally determined in accordance with the laws applicable to the collection of its own taxes. However, a revenue claim of an applicant country accepted for collection will not have, in the requested country, any priority accorded to the revenue claims of the requested country.

If the accepting country is the United States, it will treat the claim as an assessment under U.S. law against the taxpayer as of the time the application is received; if the accepting country is Canada, it will treat the claim as an amount payable under the Income Tax Act, the collection of which is not subject to any restriction.

Nothing in the assistance in collection article shall be construed as creating or providing any rights of administrative or judicial review of the applicant country's finally determined revenue claim by the requested country, based on any such rights that may be available under the laws of either country. On the other hand, if, at any time pending execution of a request for assistance under this provision, the applicant country loses the right under its internal law to collect the revenue claim, its competent authority will promptly withdraw the request for assistance in collection.

In general amounts collected under the assistance in collection article are to be forwarded to the competent authority of the applicant country. Unless the competent authorities otherwise agree, the ordinary costs incurred in providing assistance are to be borne by the requested country, and any extraordinary costs by the applicant country.

Nothing in the proposed new article is to be construed as requiring either country to carry out administrative measures of a different nature from those used in the collection of its own taxes, or that would be contrary to its public policy (*ordre public*). The competent authorities shall agree upon the mode of application of the article, including agreement to ensure comparable levels of assistance to each country.

The proposed new article is similar to the provision on assistance in recovery of tax claims that is in the Convention on Mutual Administrative Assistance in Tax Matters, among the member States

of the Council of Europe and the OECD.[50] The Convention entered into force on April 1, 1995. The Convention differs from the proposed protocol in that it involves multiple parties, not two parties; the negotiating considerations may have differed from those that were relevant in negotiating the proposed protocol. The United States ratified the Convention subject to a reservation that the United States will not provide assistance in the recovery of any tax claim, or in the recovery of an administrative fine, for any tax.

At that time,[51] it was pointed out that by entering into such a reservation, the United States might forego significant benefits. The reservation, could, for example, prevent the United States from collecting the maximum amount of taxes due it by causing it not to be able to avail itself of the collection procedures of another government. On the other hand, it was noted that a reservation with respect to this issue could be appropriate, in that the United States should not be obligated to help another government collect its uncontested tax claims against U.S. residents or to collect its claims against its own residents.[52]

Inclusion of the assistance in collection provision in the proposed Canadian protocol may lead to increased interest in the inclusion of similar provisions in protocols or treaties with other governments. In each instance, consideration may need to be given as to whether it is appropriate for the United States to assist in the collection of another government's taxes. This analysis may involve an evaluation of both the substantive and procedural elements of the other government's taxes, as well as an analysis of broader policy issues, such as the relative compatiblity of the other government's legal systems and individual protections with those of the United States.

G. Arbitration of Competent Authority Issues

In a step that has been taken only recently in U.S. income tax treaties (i.e., beginning with the 1989 income tax treaty between the United States and Germany), the proposed treaty would make provision for a binding arbitration procedure, if both competent authorities and the taxpayers involved agree, for the resolution of those disputes in the interpretation or application of the treaty that it is within the jurisdiction of the competent authorities to resolve. This provision would have effect only after diplomatic notes are exchanged between Canada and the United States. Consultation between the two countries regarding whether such an exchange of notes should occur would take place after a period of three years after the proposed treaty has entered into force.

Generally, the jurisdiction of the competent authorities under the proposed treaty would be as broad as it is under any U.S. income tax treaties. Specifically, the competent authorities would be re-

[50] Section II, Articles 11 through 16, Senate Treaty Doc. 101–6, November 8, 1989.

[51] See Joint Committee on Taxation, *Explanation of Proposed Convention on Mutual Administrative Assistance in Tax Matters,* (JCS–14–90), June 13, 1990.

[52] For example, in 1951, the Senate considered income tax treaties for Greece, Norway, and South Africa which, as originally submitted to the Senate, would have obligated the treaty countries to provide broad tax collection assistance to each other. The Senate gave its advice and consent to those treaties subject to an understanding that the countries would only provide such collection assistance as would be necessary to ensure that the exemption or reduced rate of tax granted by the treaties would not be enjoyed by persons not entitled to those benefits.

quired to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the treaty. They could also consult together regarding cases not provided for in the treaty.

As an initial matter, it is necessary to recognize that there are appropriate limits to the competent authorities' own scope of review.[53] The competent authorities would not properly agree to be bound by an arbitration decision that purported to decide issues that the competent authorities would not agree to decide themselves. Even within the bounds of the competent authorities' decision-making power, there likely would be issues that one or the other competent authority would not agree to put in the hands of arbitrators. Consistent with these principles, the Technical Explanation expects that the arbitration procedures will ensure that the competent authorities generally would not accede to arbitration with respect to matters concerning the tax policy or domestic tax law of either treaty country.

In approving ratification of the U.S.-Germany treaty, the Committee indicated a belief that the tax system potentially may have as much to gain from use of a procedure, such as arbitration, in which independent experts can resolve disputes which otherwise may impede efficient administration of the tax laws. However, the Committee also believed that the appropriateness of such a clause in a future treaty depended strongly on the other party to the treaty, and the experience that the competent authorities would have under the provision in the German treaty. To date there have been no arbitrations of competent authority cases under the German treaty, and few tax arbitrations outside the context of that treaty.

H. Treaty Override

The proposed protocol contains a provision that requires the appropriate authorities to consult on appropriate future changes to the treaty whenever the internal law of one of the treaty countries is changed in a way that unilaterally removes or significantly limits any material benefit otherwise provided under the treaty. When a treaty partner's internal tax laws and policies change, it may be desirable that treaty provisions designed and bargained to coordinate the predecessor laws and policies be reviewed to determine how those provisions apply under the changed circumstances. There are cases where giving continued effect to a particular treaty provision does not conflict with the policy of a particular statutory change. In certain other cases, however, a mismatch between an existing treaty provision and a newly-enacted law may exist, in which case the continued effect of the treaty provision may frustrate the policy of the new internal law. In some cases the contin-

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[53] In discussing a clause permitting the competent authorities to eliminate double taxation in cases not provided for in the treaty, Representative Dan Rostenkowski, then Chairman of the House Committee on Ways and Means, submitted the following testimony in 1981 hearings before the Senate Committee on Foreign Relations:

> Under a literal reading, this delegation could be interpreted to include double taxation arising from any source, even state unitary tax systems. Accordingly, the scope of this delegation of authority must be clarified and limited to include only noncontroversial technical matters, not items of substance.

Tax Treaties: Hearings on Various Tax Treaties Before the Senate Committee on Foreign Relations, 97th Cong., 1st Sess. 58 (1981).

ued effect of the existing treaty provision would be to give an unbargained-for benefit to taxpayers or one of the treaty partners, especially if changes in taxpayer behavior result in a treaty being used in a way that was not anticipated when the original bargain was struck. At that point, the treaty provision in question may no longer eliminated double taxation or prevent fiscal evasion; if not, its intended purpose would no longer be served.[54] Strict adherence to all existing treaty provisions pending bilateral agreement on changes may impose significant limitations on the implementation of desired tax policy. Termination of the entire treaty may not be a desirable alternative.

[54] See the discussion of the Senate Committee on Finance's view on this subject in Sen. Rept. No. 100–445, 100th Cong., 2d Sess. at 323 (1988) (relating to a provision that would have modified the 1954 transition rule in Code sec. 7852(d) governing the relationship between treaties and the Code, to clarify that it does not prevent application of the general rule providing that the later in time of a statute or a treaty controls).