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

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed protocol to the income tax treaty between the United States and Canada. The proposed treaty protocol was signed on July 29, 1997.[2] The proposed protocol would amend the income tax treaty between the United States and Canada signed on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, and March 17, 1995 (the "existing treaty"). The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed protocol on October 7, 1997.

Part I of the pamphlet provides a summary with respect to the proposed protocol. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains an article-by-article explanation of the proposed protocol. Part IV is a discussion of issues with respect to the proposed protocol.

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[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–19–97), October 6, 1997.

[2] For a copy of the proposed tax treaty, see Senate Treaty Doc. 105–29, September 23, 1997.

I. SUMMARY

The principal purposes of the existing treaty between the United States and Canada are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty would make two modifications to the existing treaty. First, the proposed protocol modifies the provision in the existing treaty that allows a country to tax the gains of a resident of the other country from the sale of stock of a real property holding company to limit the reach of that provision only to stock of companies that are resident in the first country. Second, the proposed protocol replaces the provision in the existing treaty that allows social security benefits to be taxed only by the source country with a provision that allows such benefits to be taxed only by the recipient's country of residence.

II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview briefly describes certain U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. This overview also discusses the general objectives of U.S. tax treaties and describes some of the modifications to U.S. tax rules made by treaties.

A. U.S. Tax Rules

The United States taxes U.S. citizens, residents, and corporations on their worldwide income, whether derived in the United States or abroad. The United States generally taxes nonresident alien individuals and foreign corporations on all their income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income"). The United States also taxes nonresident alien individuals and foreign corporations on certain U.S.-source income that is not effectively connected with a U.S. trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are related to effectively connected income. A foreign corporation also is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business. In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.

U.S.-source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation are subject to U.S. tax at a rate of 1 or 4 percent of the premiums. These taxes generally are collected by means of withholding.

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In

addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real property.

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Special rules apply to treat as foreign-source income (in whole or in part) interest paid by certain U.S. corporations with foreign businesses and to treat as U.S.-source income (in whole or in part) dividends paid by certain foreign corporations with U.S. businesses. Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit foreign income taxes paid against the U.S. tax imposed on their foreign-source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax liability on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide basis (as opposed to a "per-country" basis). The limitation is applied separately for certain classifications of income. In addition, a special limitation applies to the credit for foreign taxes imposed on foreign oil and gas extraction income.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid and its foreign tax credit limitation calculations for the year the dividend is received.

B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from,

that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit, in specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the source country in treaties are premised on the assumption that the country of residence will tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by both the countries. Treaties generally provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums (e.g., presence for a set number of days or earnings in excess of a specified amount). Treaties address passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that such income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on such income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely) in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration

or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. The Internal Revenue Service (the "IRS"), and the treaty partner's tax authorities, also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between countries is enhanced further under treaties by the inclusion of a "competent authority" mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments.

Treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither treaty country may discriminate against enterprises owned by residents of the other country.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, treaties generally contain an "anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

III. EXPLANATION OF PROPOSED PROTOCOL

A detailed, article-by-article explanation of the proposed protocol to the income tax treaty between the United States and Canada is set forth below.

Article 1

The proposed protocol amends Article XIII (Gains) of the existing treaty. Under the existing treaty, gains derived by a resident of one country from the alienation of real property situated in the other country may be taxed in the other country. For this purpose, real property situated in the United States includes a U.S. real property interest. "U.S. real property interests" include interests in U.S. corporations that hold or held U.S. real property, provided that at least 50 percent of the fair market value of such corporation is (or was) attributable to U.S. real property interests. Real property situated in Canada includes stock of a company, provided that the value of the company's stock is derived principally from real property situated in Canada.

The proposed protocol provides that real property situated in the United States does not include stock of company that is not a resident of the United States. Similarly, the proposed protocol provides that real property situated in Canada includes stock of a company *that is resident in Canada* provided that the value of the company's stock is derived principally from real property situated in Canada.

Article 2

The proposed protocol amends Article XVIII (Pensions and Annuities) of the existing treaty.

The existing treaty defines the term "pensions" to include any payment under a pension or other retirement arrangement. The proposed protocol clarifies that the term "pensions" generally does not include any benefits under the social security legislation in either country paid with respect to government service.

The existing treaty provides that benefits under the social security legislation in one of the countries paid to a resident of the other country are taxable only in the source country. The proposed protocol provides that benefits under the social security legislation in one of the countries that are paid to a resident of the other country are taxable only in the recipient's country of residence. In this regard, U.S. social security benefits paid to a Canadian resident are taxable in Canada as though they were benefits under the Canada Pension Plan, except that 15 percent of such benefits is exempt from Canadian tax . Similarly, Canadian social security benefits paid to a U.S. resident are taxable in the U.S. as though they were a payment under the U.S. Social Security Act, except that a type of benefit that is not subject to Canadian tax when paid to Canadian residents is exempt from U.S. tax.

Article 3

The proposed protocol will enter into force upon the exchange of instruments of ratification. Article 1 of the proposed protocol, relating to the taxation of certain real property gains, will have effect as of April 26, 1995. Article 2 of the proposed protocol, relating to the taxation of social security benefits, generally will have effect with respect to amounts paid or credited after 1995. However, the effect of the proposed protocol with respect to amounts paid or credited after 1995 and before the calendar year in which the protocol enters into force (or, if it enters into force after August 31 of the year, before the end of the calendar year in which it enters into force) is limited.

The proposed protocol provides that, with respect to benefits paid or accrued during such period, the protocol will apply if the resident has applied to the competent authority of the source country for a refund of the tax on the benefits. In the case of benefits paid during such period by the United States to a Canadian resident, the Canadian competent authority will apply for and receive these refunds on behalf of the resident and remit to the resident the amount of such refund minus any additional tax imposed in Canada on the benefits. In this regard, the Canadian competent authority will apply for such refunds only if the additional Canadian tax imposed on the benefits is less than the tax imposed in the United States on the benefits.

The proposed protocol provides that all taxes refunded because of the protocol are refunded without interest and that any additional taxes imposed as a result of the protocol are computed as if those taxes become payable no earlier than December 31 of the year following the year the proposed protocol enters into force.

Finally, the proposed protocol provides that the competent authorities will establish procedures with respect to the refund application and will agree on additional procedures as are necessary to ensure the appropriate implementation of the protocol.

IV. ISSUES

Under the existing treaty, the right of the situs country to tax residents of the other country on gains with respect to real property in the first country extends to gains with respect to stock of certain corporations if a sufficient portion of the assets of such a corporation consist of real property in the first country. Presently, the domestic laws of both countries with respect to the taxation of nonresidents' gains from domestic real property apply to gains from the stock of *domestic* corporations that hold sufficient domestic real property. Presently, the domestic laws of neither the United States nor Canada apply to gains from the stock of *foreign* corporations that hold real property. However, legislation was introduced in Canada that would tax nonresidents on gains from the stock of *foreign* corporations that hold sufficient Canadian real property. The effective date of this legislation, which has not been enacted to date, was April 26, 1995. The proposed protocol prevents the imposition on U.S. persons of tax pursuant to the legislation. It should be noted that many of the income tax treaties between Canada and other countries similarly prevent the imposition of such tax on residents of those countries.

Prior to its amendment by the 1995 protocol, the existing treaty provided for exclusive residence country taxation of social security benefits. Following the 1995 protocol, the existing treaty provided for exclusive source country taxation of social security benefits. Under the provision in the existing treaty, U.S. social security benefits paid to Canadian residents are subject to U.S. tax; the United States imposes a 30-percent withholding tax on 85 percent of the amount of social security benefits paid to nonresident alien individuals, for an effective tax rate of 25.5 percent. Similarly, under this provision, Canadian social security benefits paid to U.S. residents are subject to Canadian tax; Canada imposes a withholding tax of 25 percent on social security benefits of nonresident alien individuals, unless the individual elects to file a Canadian tax return and pay tax at regular graduated rates.

The source country tax rules provided with the 1995 protocol have been criticized by residents of both Canada and the United States. The 25.5 percent U.S. withholding tax on U.S. social security benefits paid to Canadian residents may be significantly higher than the Canadian tax that would be imposed on such amounts, particularly in the case of lower-income individuals. On the other hand, while the Canadian tax on Canadian social security benefits paid to U.S. residents may be reduced from the 25 percent withholding tax, U.S. residents can obtain such reductions only by filing a Canadian income tax return. The proposed protocol addresses

these concerns by providing for exclusive residence country taxation of social security benefits.