[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED INCOME TAX TREATY (AND PROPOSED PROTOCOLS) BETWEEN THE UNITED STATES AND CANADA

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

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PREPARED BY THE STAFF

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INTRODUCTION

This pamphlet provides an explanation of the proposed income tax treaty between the United States and Canada as amended by two proposed protocols. The proposed treaty was signed on September 26, 1980, and was amplified by an exchange of notes signed the same date. The proposed first protocol was signed on June 14, 1983, and was also amplified by an exchange of notes signed the same date. A competent authority agreement, to be renewed on ratification of the proposed treaty, was concluded on January 26, 1984. The proposed second protocol was signed on March 27, 1984. A similar treaty between the two countries, effective since 1942, is currently in force. The proposed treaty and proposed protocols have been scheduled for a public hearing on April 26, 1984, by the Senate Committee on Foreign Relations.

Before amendment by the two proposed protocols, the proposed treaty was the subject of hearings before the Senate Committee on Foreign Relations on September 24, 1981.[1] The committee did not issue a report with respect to the proposed treaty before amendment by the proposed protocols.

The proposed treaty is similar to other recent U.S. income tax treaties, the proposed 1981 U.S. model income tax treaty (the "U.S. model treaty"), and the model income tax treaty of the Organization of Economic Cooperation and Development (the "OECD model treaty"). However, there are certain important deviations from the U.S. model treaty, in part reflecting the close economic and physical ties between the two countries.

The first part of the pamphlet is the summary of the applicable provisions of the proposed treaty. The second part provides an overview of U.S. tax rules relating to international trade and investment and U.S. tax treaties in general. This is followed in part three by a detailed, article-by-article explanation of the proposed treaty.

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[1] For a description of the treaty before amendment, see Staff of the Joint Committee on Taxation, "Explanation of Proposed Income Tax Treaty Between the United States and Canada," JCS-48-81, September 22, 1981.

I. SUMMARY

In General

The principal purposes of the proposed income tax treaty between the United States and Canada are to reduce or eliminate double taxation of income earned by citizens and 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 is intended to continue to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these objectives are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty contains the standard tax treaty provision that neither country will tax the business income derived from sources within that country by residents of the other unless the business activities of the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles VII and XIV). Similarly, the treaty contains the standard "commercial visitor" exemptions under which residents of one country performing personal services in the other will not be required to file tax returns or pay tax in the other unless their contact with the other exceeds certain specified minimums (Articles XIV, XV, XVI, and XVII). The proposed treaty provides that dividends, interest, royalties, capital gains and certain other income derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles X, XI, XII, and XIII). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed on a restricted basis by the source country (Articles X, XI, and XII).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief of the potential double taxation by the country of residence allowing a foreign tax credit or, in a limited case, a partial exemption.

This treaty contains the standard provision (the "saving clause") contained in U.S. tax treaties that each country retains the right to tax its citizens and residents as if the treaty had not come into effect (Article XXIX). In addition, it contains the standard provision that the treaty will not be applied to deny any taxpayer any benefits he would be entitled to under the domestic law of the country or under any other agreement between the two countries

(Article XXIX); that is, the treaty will be applied only to the benefit of taxpayers.

The treaty differs in certain respects from many U.S. income tax treaties and the U.S. model. It also differs in significant respects from the present treaty. Many of these differences accrue to the benefit of U.S. businesses.

(1) The proposed treaty does not generally cover U.S. citizens who are not also U.S. residents. The U.S. model does cover such U.S. citizens. However, the U.S. has rarely been able to negotiate coverage for nonresident citizens.

(2) The proposed treaty does not contain a definition of the term "business profits," although certain categories of business profits are defined in other articles. This leaves to local law the definition of that term in some cases, and accordingly local law sometimes controls which profits are attributed to a permanent establishment and can be taxed by the country of source. Most U.S. treaties, and the U.S. model, define the term business profits.

(3) The transportation article (Article VIII) covers income from the operation or rental of motor vehicles and railway cars. Income derived by a common carrier which is a resident of one country from the carriage of passengers or freight from the country of residence to the other country is taxable only in the country of the carrier's residence. Also, the countries give up the right to tax income that a resident of the other country earns from the short-term (183 days or less) use or lease of rolling stock or motor vehicles in the host country. This provision reflects Canada's physical proximity to the United States.

(4) The limit on the dividend withholding tax that the country of source may impose is 10 percent in the case of a direct investor and 15 percent in all other cases (Article X). The United States generally seeks a 5 percent limit on direct dividends. The present treaty, however, allows a 15 percent rate.

(5) The treaty does not permit U.S. shareholders in Canadian corporations any relief similar to the imputation credit allowed Canadian shareholders. The United States has obtained relief in the United Kingdom and French treaties.

(6) The withholding tax on interest is limited to 15 percent (Article XI), the same as under the present treaty. Exemptions are provided in some limited cases such as interest on commercial credit. The U.S. model exempts interest from tax at source (provides a zero rate). A zero rate is not generally achieved in U.S. treaties, but it has been achieved in some cases for interest earned by banks on loans made to the source country.

(7) The withholding tax on royalties is limited to 10 percent generally and is eliminated for certain copyright royalties (Article XII). Movies and certain television royalties are not copyright royalties and thus may be taxed at source at 10 percent. The present treaty allows a 15 percent rate generally, and also exempts copyright royalties from tax at source. The U.S. model exempts royalties from tax at source. It does not distinguish between copyright and other royalties.

(8) The language of the capital gains provisions (Article XIII) would give Canadians who owned U.S. real estate on the date the treaty is signed a step-up in basis for purposes of computing gain

on the sale of the property to the effective date of the treaty. The present treaty is the only U.S. treaty that exempts gains from the sale of real property from tax.

(9) The treaty permits a resident of one country a charitable contribution deduction for donations to charities of the other country (Article XXI). This provision is not found in the U.S. model or most other U.S. income tax treaties. It is contained in the present treaty.

(10) The nondiscrimination provision is more limited than the model provisions and other provisions found in many treaties. For example, it does not cover residents of one country who own stock in a corporation of the other country. The provision is, however, considerably broader than the limited provision in the present treaty.

(11) The proposed treaty would exempt certain entities (such as charitable organizations) that are tax-exempt in their home countries from tax in the other country. An exemption from tax at source is also provided for dividends and interest paid to pension plans and feeder entities resident in the other country. An exemption from the U.S. excise tax on private foundations is provided a Canadian exempt organization that receives substantially all of its support from non-U.S. persons.

(12) The proposed treaty contains a provision designed to limit its benefits to residents of the two countries that is narrower than similar provisions in the U.S. model treaty and some other recent treaties.

(13) The second protocol to the proposed treaty prevents the United States from taxing social security payments made to Canadian residents who are not U.S. citizens. The U.S. model, and some recent U.S. treaties, retain the right of the United States to tax these payments.

Issues

The proposed treaty (and proposed protocols) presents the following specific issues:

(1) ***Nondiscrimination.***—Canada's tax system evidently contains certain provisions that discriminate against foreign investors as opposed to Canadian investors. For example, it is understood that in certain cases Canadian corporations receive a surtax exemption if they are owned by Canadians but not if they are owned by foreign persons. A further concern is that Canada may require higher equity-debt ratios of foreign-owned corporations than of Canadian-owned corporations.

The U.S. model and most recent U.S. income tax treaties generally contain a nondiscrimination clause that obligates the treaty countries to tax local corporations owned by residents of the other country no more harshly than locally owned local corporations. The United States frequently agrees by treaty to treat U.S. corporations owned by residents of the treaty partner as well as it treats U.S. corporations owned by U.S. persons. The nondiscrimination provision of the proposed treaty, however, applies a "most favored nation" approach by requiring each country to treat domestic corporations owned by residents of the other country as well as it treats domestic corporations owned by residents of any third country. Thus, the proposed treaty would indirectly obligate the United

States to treat U.S. corporations owned by Canadians as well as it treats U.S. corporations owned by U.S. persons. Canada, by contrast, has not promised in any of its treaties to treat foreign-owned Canadian corporations as well as Canadian-owned Canadian corporations. Therefore, Canada need not treat U.S.-owned Canadian corporations as well as it treats Canadian-owned Canadian corporations. On the one hand, it could be argued that this nondiscrimination provision represents a significant concession by the United States without a corresponding Canadian concession. On the other hand, it can be argued that U.S. internal law does not discriminate against foreign-owned U.S. corporations, so that the United States has not made a significant concession on this point.

The United States generally insists that its tax treaties contain a broad nondiscrimination provision that would prohibit the treaty partner from discriminating against U.S. investors. At the insistence of Canada, the nondiscrimination provision in the proposed treaty is not so comprehensive as that sought by the United States or as that contained in the U.S. or the OECD model treaties or the U.N. treaty guidelines. However, the nondiscrimination provision in the proposed treaty is much broader than that contained in the present treaty with Canada which applies only to individual U.S. citizens resident in Canada. The provision is the broadest agreed to by Canada in any of its treaties.

This raises the issue of whether the United States should enter into a treaty that countenances the right of a developed country to discriminate against U.S. investors in circumstances not generally permitted in tax treaties. At the present, staff does not have sufficient information to identify and evaluate the provisions of Canadian tax law which may be viewed as discriminating against U.S. investors but which would be permitted under the proposed treaty language.

(2) ***Mineral royalties.***—The present treaty contains an overall 15-percent limit on the rate of tax that either country can impose on investment income paid to residents of the other country. The proposed treaty removes this overall limitation but replaces it with limitations on the level of source basis taxation of various types of investment income. There is, however, no limitation on taxation of mineral rents and royalties. Accordingly, the Canadian tax on mineral royalties will be increased to the Canadian statutory rate (25 percent of the gross amount of the royalties). (The U.S. tax will increase to 30 percent of the gross royalties.) In an exchange of notes accompanying the first protocol, the countries have promised to negotiate if either increases its statutory rate. The U.S. and OECD models do not contain a limitation on the taxation of mineral royalties.

(3) ***Real property.***—Under the proposed treaty, certain Canadian investors get an effective step-up in the basis of their U.S. real property interests (for purposes of computing the U.S. tax on sale of the property interests) to the effective date of the new treaty. This treatment generally applies if a Canadian investor either owned the interest on September 26, 1980, the date of signature of the proposed treaty, or acquired it in a non-recognition transaction from a Canadian investor who owned it on that date. Residents of other countries will not get this kind of basis step-up for U.S. tax

purposes. Some may argue that Canadian investors should not obtain such preferential treatment on their U.S. real estate investments. Conversely, others may argue that the limitations on taxing real estate related gains should be expanded to protect U.S. investors in Canada from Canadian tax.

The present treaty exempts gain from tax at source. Accordingly, it can be argued that a step-up in basis would be a reasonable transition rule.

The proposed treaty will allow treaty exemption for U.S. real estate gains of Canadian investors through the first taxable year that begins on or after January 1 of the year of ratification. If ratification occurs in late 1984, then U.S. real estate gains of Canadian investors will generally be exempt through at least all of 1985. In the case of a taxpayer with a fiscal year beginning December 1, gains will be exempt through November 30, 1986. Treaty exemption for non-Canadian investors will end at the end of 1984.

In imposing tax on foreign persons who dispose of U.S. real property interests, Congress provided a special rule for any new treaty that is renegotiated to resolve conflicts between an existing treaty and the U.S. tax. The Act imposing the tax (the Foreign Investment in Real Property Tax Act, included in Public Law 96-499) provided that any new treaty that resolved such conflicts and that was signed before January 1, 1985, could delay imposition of the tax until the date (not later than two years after the new treaty was signed) specified in the new treaty. The proposed first protocol resolves conflicts between the existing treaty and the U.S. tax. However, it delays imposition of the tax for a greater period than that contemplated by Congress. That protocol was signed on June 14, 1983. This raises the issue whether the treaty should extend the effective date of the U.S. tax beyond June 14, 1985, the date two years after signature of the protocol resolving the conflicts.

Moreover, this delayed effective date may allow certain Canadian investors additional time to avoid virtually all U.S. and Canadian tax on the appreciation of the U.S. real property prior to the delayed effective date. For example, assume that a Candian corporation owns all the shares of a U.S. corporation whose principal asset is U.S. real property that it uses in U.S. business. The U.S. corporation liquidates into the Canadian corporation. That transaction is free of Canadian tax, and the Canadian corporation takes a stepped-up basis for Canadian tax purposes in the U.S. real property. The transaction is also exempt from U.S. tax under the current treaty. The Canadian corporation takes a carryover basis for U.S. tax purposes, but if it sells the property before the delayed effective date, the sale may be free of U.S. tax. The sale will bear Canadian tax only to the extent of the appreciation between the liquidation and the sale. This example presents the issue whether a transfer during this extra year should avoid any significant U.S. or Canadian tax on appreciation that occurs before the delayed effective date of the proposed treaty, even for property not eligible for the treaty's step-up rule. The committee could make clear its view that a proper purpose of income tax treaties is to prevent double taxation, but that, as a general matter, treaties should not eliminate U.S. tax on income that is not subject to tax in any other country.

(4) ***Exempt organizations.***—Unlike other U.S. tax treaties, the proposed treaty would exempt charitable organizations of either country from tax imposed by the other. In addition, Canadian private foundations which receive substantially all their support from non-U.S. persons would be exempt from the 4-percent U.S. excise tax on income of private foundations. An exemption is also provided for pension funds and feeder entities but the exemption is limited to interest and dividends received from sources within the other country.

(5) ***Conventions.***—The proposed treaty contains a provision that would permit U.S. persons to deduct for U.S. income tax purposes those expenses incurred in attending business conventions in Canada. At the time this provision was negotiated, deductions for conventions held in all foreign countries, including Canada, were subject to substantial restrictions pursuant to amendments to the Code made by the Tax Reform Act of 1976. However, the Code was amended in 1980 to permit deductions for conventions in Canada and Mexico on the same basis as those held in United States and its possessions. (In 1983, the Code was amended to permit deductions for conventions in certain Caribbean Basin countries that exchange tax information with the United States.) Accordingly, the treaty provision would not have any impact on U.S. taxpayers attending Canadian conventions. Unless a contrary intention is expressed by the Senate, however, the inclusion of this provision in the treaty could be taken as precedent for other negotiations. It should be noted that Canada also has statutory provisions denying Canadian taxpayers deductions for attending foreign business conventions, so the principal impact of the provision is to allow Canadians deductions for Canadian tax purposes for attending business conventions in the United States.

(6) ***Foreign tax credit.***—One issue involving the foreign tax credit is which Canadian taxes are creditable for U.S. purposes. Treasury's technical explanation says that the Canadian general corporate tax will continue to be creditable even though Canada imposes a flat rate tax on natural resource income that is not deductible in computing the general corporate tax. Canada has imposed a flat rate tax on natural resource income with an effective 12-percent rate.

Another issue is whether Canadian taxes that are creditable only by virtue of the treaty should be permitted to offset U.S. tax on income from other foreign countries. Before amendment by the proposed protocol, the proposed treaty would not have allowed that result. After amendment by the proposed protocol, the proposed treaty allows that result. If the treaty allows taxpayers to credit otherwise noncreditable Canadian taxes that are high, U.S. taxpayers who pay such taxes may have an incentive to invest in low tax foreign countries rather than in the United States. However, the Canadian taxes that the treaty specifically makes creditable might very well be creditable anyway under Treasury regulations.

(7) ***Imputation credit.***—Canada has a modified "imputation" corporate tax system that provides some relief to resident shareholders from the double taxation of corporate earnings. Individual shareholders resident in Canada who receive dividends from a Canadian corporation must gross up that dividend by 50 percent of

the dividend. The full dividend plus the gross-up is included in income and is taxed. However, an individual shareholder may credit an amount equal to one-half of the dividends against his tax liability. Nonresident shareholders do not receive the imputation credit under Canadian law. Accordingly, nonresident shareholders may be subject to a higher combined corporate and personal tax than a Canadian shareholder would be. Relief is granted to U.S. shareholders under the U.S. treaties with France and the United Kingdom, which have imputation corporate tax systems similar to Canada's. The issue raised is whether the United States should insist on greater relief for its shareholders in Canadian companies. The reduction of the dividend withholding tax does provide some relief. However, the imputation credit may give Canadian shareholders a greater Canadian tax reduction than the withholding tax reduction gives comparable U.S. shareholders.

(8) ***Canadian legislation interpreting treaties.***—On June 23, 1983, the Canadian Government introduced legislation (the proposed "Income Tax Conventions Interpretation Act") in Parliament that would provide that, absent an indication to the contrary, undefined treaty terms are to have the meaning that they have under internal law as it changes from time to time. This legislation would overrule *The Queen* v. *Melford Developments, Inc.*, 82 Dominion Tax Cases 6281 (1982), decided by the Supreme Court of Canada, which held that such treaty terms have the meaning they had under internal law at the time of the making of the treaty.

That proposed Canadian legislation would provide that, notwithstanding any tax treaty, Canada includes and has always included the Canadian Continental Shelf. Therefore, Canada would have the right to tax income arising on its Continental Shelf. The proposed treaty does not affect that proposed legislation. Under the proposed treaty, income earned on the Canadian Continental Shelf would be subject to Canadian tax. Under the present treaty, there is no explicit reference to the Canadian Continental Shelf, and thus the treatment of the Canadian Continental Shelf is unclear. The retroactive application of the legislation's proposed definition of Canada was of particular concern to U.S. drilling contractors that operated on the Canadian Continental Shelf.

The Canadian Government has reintroduced the proposed Income Tax Conventions Interpretations Act, but has made it prospective for taxable years ending after June 23, 1983. In addition, a January 26, 1984, competent authority agreement has substantially restricted the ability of Canada to impose tax on drilling contractors that operate on the Canadian Continental Shelf. This restriction applies retroactively as well as prospectively.

In addition, the proposed Income Tax Interpretations Act contains a provision designed to prevent non-Canadian taxpayers from using treaties to lower their Canadian taxes below the taxes that comparable Canadian taxpayers would pay. The current U.S.-Canada treaty allows, in computing the profits of a Canadian permanent establishment of a U.S. resident, the deduction of all expenses reasonably allocable to that permanent establishment. Canada does not allow taxpayers (whether or not Canadian residents) to deduct certain expenses, including the petroleum and gas revenue tax or provincial income or mining taxes or resource royalties. Canada, by statute, allows a "resource allowance" deduction; this deduction is at least in part in lieu of a deduction for these actual expenses incurred in the petroleum business. Some U.S. taxpayers with Canadian permanent establishments contend that they may deduct, for Canadian purposes, both (1) the statutory resource allowance and (2) the actual expenses that Canada's statute makes nondeductible. The proposed Canadian legislation makes it clear that nonresidents of Canada that do business in Canada through Canadian permanent establishments may deduct only the amounts deductible by a comparably situated Canadian resident. This legislative provision, too, will apply only to taxable years ending after June 23, 1983. The proposed treaty, too, makes it clear that it does not allow a permanent establishment to deduct any expenditure that is not generally allowed under the tax laws of the country where the permanent establishment is located.

(9) ***Anti-treaty shopping provisions.***—Many recent U.S. treaties (and the U.S. model) contain provisions that limit the use of the treaty by corporations and other legal entities to those that are controlled by persons who are residents of the treaty partner. The purpose of these provisions is to prevent third country residents from establishing an entity in a treaty partner to take advantage of reduced withholding rates or other treaty benefits ("treaty shopping"). The proposed treaty contains only limited anti-treaty shopping provisions. These provisions deny treaty benefits only to certain trusts and to Canadian nonresident owned investment companies. While an argument might be made that a broader anti-treaty shopping provision is appropriate, Canada is a high tax country that imposes taxes on resident entities at rates comparable to U.S. rates. Canada also imposes significant withholding taxes on payments from Canadian entities to foreign investors. Also, Canada has a history of concern about tax avoidance and evasion. The one concern would be that abuse possibilities could develop in the future, and it has proved difficult to renegotiate treaties once abuses develop.

(10) ***Exemption for social security payments to Canadian residents.***—In 1983, Congress imposed a 30-percent withholding tax on one-half of the amount of social security benefit payments to nonresident aliens. The proposed treaty, as amended by the proposed second protocol, prevents the United States from taxing benefit payments to Canadian residents (unless they are U.S. citizens). The U.S. model treaty retains the right of the United States to tax these payments. Some existing treaties, however, such as those with Japan and the United Kingdom, prevent U.S. taxation of social security payments made to residents of the treaty partner (unless they are U.S. citizens). In imposing the tax on social security benefit payments to nonresident aliens, Congress indicated that it did not intend to override treaties in force at the time of the enactment of the legislation. This treatment in the proposed treaty raises the issue whether new treaties, submitted for ratification after imposition of the tax on social security benefit payments to nonresident aliens, should prevent imposition of that tax.

(11) ***Denial of Canadian tax deductions for advertising carried by U.S. broadcasters.***—In 1976, the Canadian Parliament amended the Canadian tax law to deny deductions, for purposes of computing

Canadian taxable income, for an advertisement directed primarily to a market in Canada and broadcast by a foreign television or radio station. This provision, which supplemented a similar provision for print media, became fully effective in 1977. The purpose of this provision was to strengthen the market position of Canadian broadcasters along the U.S.-Canadian border.

At the time Canada adopted this provision, the United States and Canada were renegotiating the income tax treaty between the two countries. The Treasury Department negotiators raised U.S. concerns with the Canadians, but the Canadian negotiators did not negotiate on the subject of this provision. The proposed treaty does not address the issue.

The Senate Committee on Finance has reported a bill (H.R. 3398) that includes a provision that would deny deductions or expenses of advertising primarily directed to U.S. markets and carried by a foreign broadcaster, if the broadcaster were located in a country that denied its taxpayers a deduction for advertising directed to its markets and carried by a U.S. broadcaster. Although the bill does not mention Canada by name, Canada is the only known country to which the bill would apply. The Senate began consideration of that bill on March 2, 1984, but returned it to the calendar on that date by unanimous consent.

II. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND TAX TREATIES

A. United States Tax Rules

The United States taxes U.S. citizens and residents and U.S. corporations on their worldwide income. The United States taxes nonresident alien individuals and foreign corporations on their U.S. source income which is not effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "noneffectively connected income"). They are also taxed on their U.S. source income and certain limited classes of foreign source income which is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income.")

Income of a nonresident alien or foreign corporation which is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent they are related to income that is effectively connected.

U.S. source fixed or determinable annual or periodical income (including interest, dividends, rents, salaries, wages, premiums, and annuities) that is not effectively connected income and that is received by a nonresident alien or foreign corporation is subject to tax at a rate of 30 percent of the gross amount paid. This tax is often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty.

The 30-percent (or lower treaty rate) tax imposed on U.S. source noneffectively connected income paid to foreign persons is collected by means of withholding (hence these taxes are often called withholding taxes).

Certain exemptions from the gross tax are provided. Bank account interest is defined as foreign source interest and, therefore, is exempt. Exemptions are also provided for certain original issue discount and for income of a foreign government from investments in U.S. securities. U.S. treaties also provide for exemption from tax in certain cases.

U.S. source noneffectively connected capital gains of nonresident individuals and foreign corporations are generally exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien who is present in the United States for at least 183 days during the taxable year and (2) certain gains from the sale of U.S. real estate.

Prior to June 18, 1980, noneffectively connected capital gains from the sale of U.S. real estate were subject to U.S. taxation only if received by a nonresident alien who was present in the United States for at least 183 days. However, in the Omnibus Reconciliation Act of 1980 a provision was added to the Internal Revenue Code that the sale, exchange, or disposition of U.S. real estate by a foreign corporation or a nonresident alien would be taxed as effectively connected income. Also taxable under the legislation are dispositions by foreign investors of their interests in certain U.S. corporations and other entities whose assets include U.S. real property and associated personal property.

The source of income received by nonresident aliens and foreign corporations is determined under rules contained in the Internal Revenue Code. Interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation are considered U.S. source income. However, if a U.S. corporation derives more than 80 percent of its gross income from foreign sources, then dividends and interest paid by that corporation will be foreign source rather than U.S. source. Conversely, dividends and interest paid by a foreign corporation, at least 50 percent of the income of which is effectively connected income, are U.S. source to the extent of the ratio of its effectively connected income to total income.

Rents and royalties paid for the use of property in the United States are considered U.S. source income. The property used can be either tangible property or intangible property (e.g., patents, secret processes and formulas, franchises and other like property).

Since the United States taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person may be taxed by the county in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation by generally allowing U.S. persons to credit their foreign income taxes 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 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. This limitation generally is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income.

A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may credit foreign income taxes paid or deemed paid by that corporation on earnings that are received as dividends. These deemed paid taxes are included in total foreign taxed paid for the year the dividend is received and go into the general pool of taxes to be credited.

Separate limitations on the foreign tax credit are provided for certain interest and for DISC dividends; also, special rules are provided for taxes imposed on oil and gas extraction income.

B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, the treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives; the treaty provisions modify the generally applicable statutory rules with provisions which take into account the particular tax system of the treaty country. Given the diversity of tax systems, it would be virtually impossible to develop in the Code rules which unilaterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and its treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if both countries consider the same deduction allocable to foreign sources, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in those limited situations where a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation—situations where either country taxes income received by nonresidents at rates which exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross income basis. (Most countries, like the United States, generally tax domestic source income on a gross income basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax exceeds the tax which would have been paid under the net income tax system applicable to residents.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and 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.

The objective of limiting double taxation is generally accomplished in treaties by the agreement of each country to limit, in certain specified situations, its right to tax income earned form its territory by residents of the other country. For the most part, the various rate reductions and exemptions by the source country provided in the treaties are premised on the assumption that the country of residence will tax the income in any event at levels comparable to those imposed by the source country on its residents. The 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 some cases, the treaties may provide for exemption by the residence country of income taxed by the source country pursuant to the treaty.

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by each of the two countries. Treaties also 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 branch or other permanent establishment or fixed base. The treaties 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, for example, presence for a set number of days or earnings of over a certain amount.

Treaties deal with passive income such as dividends, interest, or royalties, or capital gains, from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the U.S. generally imposes a 30 percent tax and seeks to reduce this tax (on some income to zero) in its tax treaties, in return for reciprocal treatment by the treaty partner.

In its treaties, the United States, as a matter of policy, retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect, and provides this in the treaties in the so-called "saving clause". Double taxation can also still arise because most countries will not exempt passive income from tax at the source.

This double taxation is further mitigated either by granting a credit for income taxes paid to the other country, or, in the case of some U.S. treaty partners, by providing that income will be exempt from tax in the country of residence. The United States 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 limitations of U.S. law. An important function of a treaty is to define the taxes to which it applies and to provide that they will be considered creditable income taxes for purposes of the treaty.

The treaties also provide for administrative cooperation between the countries. This cooperation includes a competent authority mechanism to resolve double taxation problems arising in individual cases, or more generally, by consultation between tax officials of the two governments.

Administrative cooperation also includes provision for an exchange of tax-related information to help the United States and its treaty partners administer their tax laws. The treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the 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 not obtainable under its laws or in the normal course of its administration, or to supply information which would disclose trade secrets or other information the disclosure of which would be contrary to public policy.

The provisions generally result in exchange of routine information, such as the names of U.S. residents receiving investment income. The Internal Revenue Service (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.

The 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 country may discriminate against its enterprises owned by residents of the other country.

III. EXPLANATION OF PROPOSED TAX TREATY AND PROPOSED PROTOCOLS

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and Canada, as modified by the proposed protocols, is presented below.

Article I. Personal Scope

The personal scope article describes the persons who may claim the benefits of the treaty.

The proposed treaty applies generally to residents of the United States and to residents of Canada, with specific exceptions designated in other articles. This application follows other U.S. income tax treaties, the U.S. model income tax treaty, and the OECD model income tax treaty. The treaty also applies, in limited cases designated in other articles, to persons who are residents of neither Canada nor the United States. Article IV defines the term "resident".

Article II. Taxes Covered

The proposed treaty applies to taxes on income and capital that either country imposes. At present, neither Canada nor the United States imposes a tax on capital.

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Internal Revenue Code. However, the proposed treaty applies to the U.S. accumulated earnings tax and the personal holding company tax only to the extent provided in Article X (Dividends), which generally prevents imposition of those taxes with respect to a Canandian corporation unless non-Canadians hold more than half of the corporation's voting power. In addition, the proposed treaty applies to certain other U.S. taxes for specified limited purposes. The proposed treaty applies to the excise tax imposed by the United States on private foundations but only to the extent necessary to implement the special provisions of Article XXI(4), which exempts from the tax only Canadian organizations that receive substantially all of their support from persons other than citizens or residents of the United States. It also applies to the social security tax but only to the extent necessary to implement the rules in Article XXIX(4) (Miscellaneous Rules), which state that, for past years, income from personal services that is not subject to U.S. income tax under the proposed treaty or the existing (1942) treaty is not subject to U.S. social security tax either.

In the case of Canada, the treaty applies to the income taxes imposed by the Federal Government of Canada under Parts I, XIII, and XIV of the Income Tax Act. These taxes will be creditable income taxes for purposes of the U.S. foreign tax credit granted by Article XXIV(1) (Relief from Double Taxation).

The proposed treaty also contains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar income taxes which either country may subsequently impose. It also will apply to any taxes on capital that either country may later impose.

Since signing of the proposed treaty in 1980, Canada has enacted a twelve-percent flat-rate tax on natural resource revenues. The proposed treaty will not cover such a flat-rate tax, so the United States need not credit it (Article XXIV (Elimination of Double Taxation)).

At the time of signing of the proposed treaty, the U.S. Treasury Department and the government of Canada agreed that the general Canadian corporate tax would be considered a substantially similar tax even if Canada were to enact a low flat-rate tax on natural resource revenues that is not deductible in computing income under the general rules of Part I of the Canadian Income Tax Act. Thus, the Canadian corporate income tax would be fully creditable even though it applied to a tax base greater than net (after resource tax) income. In 1980, the Treasury contemplated an eight-percent tax rather than the twelve-percent tax that Canada eventually enacted. The staff understands that Treasury now believes that the twelve-percent tax on oil and gas production revenues would be consistent with the 1980 understanding. It is not clear how much Canada could increase this non-deductible flat-rate tax before Treasury viewed the Canadian corporate income tax as not a substantially similar tax and thus not creditable under the proposed treaty.

Because the proposed treaty generally applies only to income taxes, it does not generally cover the U.S. excise tax on insurance premiums imposed under section 4371 of the Code, nor does it cover a similar Canadian excise tax on net insurance premiums paid by residents of Canada for coverage of a risk situated in Canada. Accordingly, the countries can continue to impose those taxes without restriction. The exchange of information under the proposed treaty is not limited to the taxes covered by the treaty. (See Article XXVI (Exchange of Information).)

Article III. General Definitions

The proposed treaty contains certain of the standard definitions found in most U.S. income tax treaties.

Under the proposed treaty, the term "Canada" means the territory of Canada, including any area beyond the territorial seas of Canada which, in accordance with international law and the laws of Canada, is an area within which Canada may exercise rights with respect to the seabed and subsoil and their natural resources. Therefore, income earned on the Canadian Continental Shelf would be covered. Under the present treaty, there is no reference to the Canadian Continental Shelf. On June 23, 1983, the Canadian Government introduced legislation (the proposed "Income Tax Conventions Interpretation Act") in Parliament that would provide that, notwithstanding any tax treaty, Canada includes and has always included the Canadian Continental Shelf. The Government reintroduced that legislation in 1984. As reintroduced, the legislation would apply only to taxable years ending after June 23, 1983. The present convention's reference to "the provinces, territories and Sable Island" has been deleted as unnecessary.

The "United States" means the United States of America, but not including Puerto Rico, the Virgin Islands, Guam or any other United States possession or territory. The definition of the United States also includes, when the term is used in a geographical sense, any area beyond the territorial seas of the United States, which, in accordance with international law and the laws of the United States, is an area within which the United States may exercise rights with respect to the sea beds and subsoil and their natural resources. The intent is to cover the U.S. Continental Shelf consistent with the definition of continental shelf contained in section 638 of the Code.

The proposed treaty would define the term "Canadian tax" as meaning the Canadian income taxes described in the Taxes Covered article (Article II) and the term "United States taxes" as meaning the U.S. taxes on income described in that article. The terms do not include capital taxes nor do they include the penalty taxes, excise tax, and social security taxes which are covered to a limited degree by the treaty.

"Person" includes an individual, an estate or trust, a company and any other body of persons. A "company" is any body corporate or any entity which is treated as a body corporate for tax purposes. The Canadian competent authority is the Minister of National Revenue or his authorized representative. The U.S. competent authority is the Secretary of Treasury or his delegate. In fact, the U.S. competent authority function has been delegated to the Commissioner of the Internal Revenue Service, who has redelegated the authority to the Associate Commissioner (Operations). The Assistant Commissioner (Examination) has been delegated the authority to administer programs for simultaneous, spontaneous, and industry-wide exchanges of information. The Director, Foreign Operations District (formerly called the Director of the Office of International Operations), has been delegated the authority to administer programs for routine and specific exchanges of information and mutual assistance in collection.

International traffic means, with reference to a resident of Canada or the United States, any voyage of a ship or aircraft to transport passengers or property except where the principal purpose of the voyage is to transport passengers or property between places within the other country. In general, profits that a resident of one country derives from the operation of ships or aircraft in international traffic are exempt from tax in the other country. Article I of the proposed first protocol clarifies this definition of "international traffic" in Article III of the proposed treaty. The proposed first protocol makes it clear that a voyage of a resident of one country that has as its principal purpose the transportation of passengers or property within that country is in international traffic. Thus, the proposed first protocol makes it clear that, for example, a flight of a U.S. airline that has the principal purpose of transporting property from Texas to Michigan is not subject to Canadian tax, even if the flight continues with a secondary purpose of transporting property to Ontario. (A similar flight of a Canadian airline would not be in international traffic and would not be exempt from U.S. (or Canadian) tax.)

In addition, the proposed first protocol makes it clear that a resident of one country need not operate or use a ship or aircraft to benefit from the exemption for international traffic. Thus, the U.S. lessor of an aircraft that a U.S. airline flew in international traffic would not be subject to Canadian tax.

The proposed treaty also contains the standard provision that, unless the context otherwise requires, or the competent authorities of the two countries establish a common meaning, all terms are to have the meaning which they have under the law of the particular country applying the proposed treaty.

Article IV. Fiscal Residence

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the countries as that term is defined in the treaty. Furthermore, double taxation is often avoided by the treaty assigning one of the countries as the country of residence where under the laws of the countries the person might be a resident of both. The term "residence" is not defined in the present treaty.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his worldwide income, while a nonresident alien is taxed only on U.S. source income and on his income that is effectively connected with a U.S. trade or business. The Code, however, does not define residence. Instead, IRS regulations state that an alien is a resident of the United States if he is actually present in the U.S. and is not a mere transient or sojourner. Whether he is a transient is determined by his intentions as to the length and nature of his stay. (See Treas. Reg. Sec. 1.871-2(b).) Generally, a corporation is resident in the United States if it is organized in the United States.

Under the proposed treaty, a person (either an individual or an entity such as a corporation or partnership) is considered to be a resident of a country if, under the laws of that country, the person is subject to taxation by that country because it is his country of domicile, residence, place of management, place of incorporation, or by reason of other criteria of a similar nature. An estate or trust will be considered to be a resident of a country only to the extent that the income it derives is subject to that country's tax, either in its hands or in the hands of its beneficiaries by that country.

This provision of the proposed treaty is generally based on the fiscal domicile article of the U.S. and OECD model tax treaties and is similar to the provisions found in other U.S. tax treaties. Consistent with most U.S. income tax treaties, citizenship alone does not establish residence. As a result, U.S. citizens residing overseas are not entitled to the benefits of the treaty as U.S. residents. This result is contrary to U.S. treaty policy as expressed in the U.S. model, but the U.S. model result has been achieved in very few treaties.

The proposed treaty provides a set of rules to determine residence in the case of a person who, under the basic treaty definition, would be considered a resident of both countries (e.g., an individual who is taxable as a resident under domestic law in both the

United States and Canada). In the case of a dual resident individual, a series of "tie-breaker" rules would apply; if one criterion does not determine a single residence, the second criterion comes into consideration, and so on. The individual will be deemed for all purposes of the treaty to be a resident of the country in which he has, first, a permanent home (where an individual dwells with his family); second, his center of vital interests (his closest economic and personal relations); third, his habitual abode; or fourth, his citizenship. If the residence of an individual cannot be determined by these tests, the competent authorities of the countries will settle the question by mutual agreement.

A corporation that is a dual resident of the United States and Canada under the general rule of Article IV, and which is created under the laws of either country (or a political subdivision), will be treated as a resident of the country in which first created. Dual residence can arise under Canadian domestic law because Canada treats a corporation as a resident if it is managed in Canada. Thus, for example, a U.S. incorporated company with its management in Canada would be resident in Canada under its internal law. However, under the proposed treaty it would be resident only in the United States. The residence of a dual resident partnership, trust, or estate, and the mode of application of the treaty to that person will be determined by the competent authorities.

An individual who is an employee performing services of a governmental nature for either country will be treated as a resident of that country if he is subject to tax by that country as a resident. The same rule applies to an employee of a local government of one of the countries. Such an individual's spouse and children are also residents of the country that employs him, provided they too are subject to tax by that country as residents. Under this rule, a U.S. citizen or resident who is employed by the United States in any foreign country would be considered a U.S. resident under the proposed treaty.

Article V. Definition of Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" which generally follows the pattern of other recent U.S. income tax treaties, the U.S. model and the OECD model.

The permanent establishment concept is one of the basic devices used in income tax treaties to avoid double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemption from, tax provided for dividends, interest, and royalties will apply, or whether those amounts will be taxed as business profits. U.S. taxation of business profits is discussed under Article VII (Business Profits).

In general, a permanent establishment is a fixed place of business through which a resident of one country engages in business in the other country. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes any building site, construction or installation project, if the site or project lasts for more than 12 months.

The use of an installation, a drilling rig or ship in a country to explore for or exploit natural resources also gives rise to a permanent establishment if the use in that country is for more than three months in any 12 month period. This 3-of-12 months rule differs from the 12-month rule of the U.S. model treaty. Before amendment by Article II of the proposed first protocol, the proposed treaty did not specify this treatment for an "installation". The proposed first protocol specifically provides that such use of an "installation" gives rise to a permanent establishment. The U.S. model treaty also specifically covers installations.

A competent authority agreement signed January 26, 1984 prescribes rules (under the existing treaty) for the Canadian tax treatment of drilling rigs that constitute Canadian permanent establishments of U.S. residents. In general, such rigs are eligible for Canadian depreciation at rates between 6-2/3 and 15 percent per year. U.S. residents who remove such rigs from Canada or who dispose of them in Canada are not subject to the Canadian rules that might impose gain (including depreciation recapture) or loss on removal or disposition. Upon entry into force of the proposed treaty, the competent authorities have agreed to reaffirm this agreement so that it will apply under the proposed treaty as well as the existing treaty. It will apply to an offshore drilling rig that constitutes a permanent establishment of a U.S. resident located in any area within the territorial seas of Canada, and in any area beyond the territorial seas of Canada which, in accordance with international law and the laws of Canada, is an area within which Canada may exercise rights with respect to the seabed and subsoil and their natural resources.

In addition, the competent authority agreement limits the right of Canada to tax a drilling rig owned by a U.S. resident or by a related person that does not constitute a Canadian permanent establishment of a U.S. resident (such as a drilling rig leased in bareboat form by a U.S. resident to another person for use in Canada). In general, such rigs are eligible for Canadian depreciation at the rate of 6-2/3 percent per year. In this case, too, U.S. residents who remove such rigs from Canada or who dispose of them in Canada are not subject to the Canadian rules that might impose gain (including depreciation recapture) or loss on removal or disposition.

If a resident of one country maintains an agent in the other country who has, and regularly exercises, the authority to enter into contracts in that other country in the name of the resident, then the resident will be deemed to have a permanent establishment in the other country with respect to the activities which the agent undertakes on its behalf. This rule does not apply where the contracting authority is limited to those activities such as storage, display, or delivery of merchandise which are excluded from the definition of permanent establishment. The proposed treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent, or other agent of independent status acting in the ordinary course of its business.

This general rule is modified to provide that a fixed place of business that is used solely for any or all of a number of specified activities will not constitute a permanent establishment. These activities include the use of facilities for storing, displaying, or delivering merchandise belonging to the resident or for the maintenance of a stock of goods belonging to the resident for storage, display, or delivery, or for processing by another person. These activities also include the maintenance of a fixed place of business for the purchase of goods or merchandise or the collection of information, for advertising or scientific research, or any other preparatory or auxiliary activities for the resident.

Thus, activity that is preparatory or auxiliary in nature would not be treated as giving rise to a permanent establishment, even though the activity is not specifically mentioned in the proposed treaty.

The determination of whether a company of one country has a permanent establishment in the other country is to be made without regard to the fact that the company may be related to a resident of the other country or to a person who engages in business in that other country. The relationship is thus not relevant; only the activities of the company being tested are relevant.

The proposed treaty would make certain changes in the present treaty that could generally limit the cases in which a permanent establishment exists. The proposed treaty would eliminate the rule in the present treaty that includes as a permanent establishment the use by a resident of one country of substantial equipment in the other country. The proposed treaty would also eliminate the provision of the present treaty under which a business is considered to have a permanent establishment if it carries on business in a country through an agent or employee who has a stock of goods or merchandise from which he regularly fills orders that he receives.

The proposed treaty specifically states that its provisions are to be applied in determining whether any person has a permanent establishment in any country. Thus, the provisions are to be applied to determine whether a resident of a country other than Canada or the United States has a permanent establishment in Canada or the United States, and whether a person resident in Canada or the United States has a permanent establishment in a third country.

Article VI. Income from Real Property

Under the proposed treaty as amended by Article III of the proposed first protocol, income from real property may be taxed in the country where the real property is located. Before amendment by the proposed first protocol, the proposed treaty specified that income from agriculture and forestry is income from real property. The proposed first protocol makes it clear that income from real property includes income from any natural resources as well as income from agriculture and forestry. For purposes of the treaty, real property will generally have the meaning provided under the laws of the country where the property is located, but will in any case include usufruct of real property, rights to explore for or to exploit mineral deposits, sources, and other natural resources. The proposed first protocol makes it clear that real property also includes rights to amounts computed by reference to the amount or value or production from mineral deposits, sources, and other natural resources. Thus, income from real property includes royalties and other payments in respect of the exploitation of natural resources (e.g., oil wells) and gains on the sale, exchange, or other disposition of the royalty rights or the underlying natural resource. The term real property also includes options or similar rights with respect to real property. Ships, boats, and aircraft will not be considered real property.

Income from real property includes income from the direct use, use in any form, renting, or alienation of the property. Income from real property does not include interest on loans secured by real property.

Under Article XIII (Gains), gains on the sale, exchange or other disposition of real property may also be taxed by the country where the property is located. Also, gain from the disposition of stock in a company whose assets consist, directly or indirectly, principally of real estate may generally be taxed in the country in which the company's real estate is located.

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business, or, in the case of a nonresident alien, he is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended, a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a U.S. real property interest, as if gain was effectively connected with a trade or business conducted in the United States. The real estate provision of Article XIII generally would not restrict the right of the United States to tax the gain from the sale of U.S. real estate under the provisions of the 1980 legislation or any similar but later enacted legislation. It also retains the right of the United States to impose relevant reporting or withholding requirements. However, the language of the article would generally allow Canadian investors a stepped-up basis on dispositions of U.S. real property interests.

The present treaty permits a resident of one country to elect to be taxed on income from real property in the other country on a net basis. The proposed treaty does not guarantee the right to such an election, but such an election is provided for U.S. real property income under the Code. Internal Canadian tax law permits a net basis election for some income from Canadian real property, but not for natural resource royalties. Also, the present treaty limits the tax a country may impose on rental or royalty income from real property to 15 percent. There is no limit in the proposed treaty. Under its domestic law, Canada would presently impose a 25 percent tax, while the United States would presently impose a 30 percent tax. In an exchange of notes on June 14, 1983, the date of signing of the proposed first protocol, the United States and Canada agreed that if either country increases the statutory tax rate that now applies to natural resource royalties paid to non-residents, upon request by either country, the two countries will promptly resume negotiations with a view to considering an amendment to the proposed treaty to provide an appropriate limit to the rate of taxation of such royalties.

Article VII. Business Profits

U.S. Code rules

United States law distinguishes between the business income and the investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30 percent rate (or lower treaty rate) of tax on its U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to U.S. source income which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income depends upon whether the income is U.S. or foreign. In general, U.S. source periodic income, such as interest, dividends, rents, wages, and capital gains, is effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All U.S. source income other than periodic income is treated as effectively connected income.

Foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. Only three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends, interest, or gain from stock or debt derived in the active conduct of a banking, financing or similar business in the United States; and certain sales income attributable to a United States sales office.

Except in the case of a dealer, trading in stocks, securities or commodities in the United States for one's own account does not constitute a trade or business in the United States and accordingly income from those activities is not taxed by the U.S. as business income. Thus, income from trading through a U.S. based employee, a resident broker, commission agent, custodian or other agent or trading by a foreign person physically present in the United States is not generally taxed as business income.

Proposed treaty rules

Under the proposed treaty, business profits of an enterprise of one country are taxable in the other country only to the extent they are attributable to a permanent establishment in the other country through which the enterprise carries on, or has carried on, business. This is one of the basic limitations on a source country's right to tax income of a nonresident under the treaty.

The taxation of business profits under the proposed treaty differs from United States rules for taxing business profits primarily in requiring more than merely being engaged in trade or business before a country can tax business profits. Under the Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the proposed treaty, on the other hand, some level of fixed place of business must be present.

The proposed treaty permits a country to tax business profits attributable to a permanent establishment that no longer exists. Thus, a country may tax business profits received in a year after the permanent establishment to which those business profits are attributable has ceased to exist. This rule applies to business profits received after the proposed treaty comes into force that are attributable to a permanent establishment that ceased to exist before the proposed treaty came into force.

Unlike most U.S. treaties and the U.S. model, the proposed treaty does not define the term "business profits." Thus, to the extent not dealt with in other Articles, the term will be defined under the law of the two countries. If the definitions cause double taxation, the competent authorities could agree on a common meaning of the term.

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there is to be attributed to a permanent establishment the business profits which it would reasonably be expected to have derived if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's-length with the resident enterprise of which it is a permanent establishment, or with any other person related to the resident. Thus, for example, this arm's-length rule applies to transactions between the permanent establishment and a branch of the resident enterprise located in a third country. Amounts may be attributed whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits, deductions are allowed for expenses, wherever incurred, which are incurred for purposes of the permanent establishment. These deductions include a reasonable allocation of executive and general administrative expenses, interest, research and development, and other expenses which are incurred for purposes of the enterprise as a whole (or for purposes of that part of the enterprise which includes the permanent establishment). Thus, for example, a U.S. company which has a branch office in Canada but which has its head office in the United States will, in computing the Canadian tax liability of the branch, be entitled to deduct a portion of the executive and general administrative expenses incurred in the United States by the head office for purposes of administering the Canadian branch. However, a country is not required to permit a deduction for an expense that is not by reason of its nature generally deductible under its tax laws.

Business profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by a permanent establishment for the account of the enterprise or by reason of the provision of executive, managerial or administrative facilities or services for the resident. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element on its purchasing activities. Likewise, the permanent establishment could be the headquarters office for the company without being taxed in the country on profits generated by that activity.

Where business profits include items of income which are dealt with separately in other articles of the treaty, those other articles, and not this business profits article, will govern the treatment of those items of income. Thus, for example, film rentals are taxed under the provisions of Article XII (Royalties), and not as business profits.

Under the proposed treaty, the only business profits that can be attributed to a permanent establishment are those derived from the assets or activities of the permanent establishment. In some cases, this rule is somewhat more restrictive than the Code rule that treats all U.S. source income, other than investment type income, as effectively connected income.

Article VIII. Transportation

As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the ship or aircraft is documented under the laws of a foreign country that grants an equivalent exemption to U.S. citizens and corporations. The United States has entered into agreements with a number of countries under which that country grants an exemption which results in the United States exempting that country's shipping.

The proposed treaty provides that income which is derived by a resident of one country from the operation of ships and aircraft in international traffic is exempt from tax by the other country. Article IV of the proposed first protocol makes it clear that this income includes certain rents from operations in international traffic, such as certain rents for the use of containers. That is, Article VIII (Transportation) rather than Article XII (Royalties) governs such income. International traffic means any transportation by ship or aircraft, except where the principal purpose of the voyage is to transport passengers or property between places in the other country (Article III(1)(d) (Definitions)).

The proposed treaty, before amendment by the proposed first protocol, provided that gains derived by a resident of one country from the disposition of ships or aircraft used principally in international traffic are exempt from tax in the other country. The proposed first protocol expands this category of assets whose disposition is tax exempt in the country not of residence to include containers, including trailers and related equipment for the transport of containers, used principally in international traffic.

The exemption applies even if a ship or aircraft is not registered in either country. Thus, for example, income of a U.S. resident from the operation of a ship flying the Liberian flag would not be subject to Canadian tax. This exemption based solely on residence is a liberalization of the rule in the present treaty that provides for an exemption only if the ship or aircraft is registered in the country of residence of the operator. The exemption also applies to income from participation in a pool, a joint business or an international operating agency which is engaged in the operation of ships and aircraft in international traffic.

The exemption for shipping and air transport profits applies to profits from the rental on a full or bare boat basis of ships or aircraft which are operated in international traffic by the lessee. (Rental on a full or bare boat basis refers to whether the ships or aircraft are leased fully equipped, manned and supplied or not.) Income from the operation in international traffic of ships or aircraft also includes income derived from the use, maintenance, or rental of containers, trailers for the inland transportation of containers, and other related equipment where the item is used in international traffic. Such income also includes income from the rental (on a full or bare boat basis) of ships, aircraft, or containers (including trailers and related equipment for the transport of containers) when the item is not used in international traffic but the income is incidental to other transportation income that is exempt from tax under the treaty.

However, a country may tax the profits of a resident of the other country from the voyage of a ship where the principal purpose of the voyage is to transport passengers or property between places in the country not of residence. Thus, for example, Canada could tax the profits of a U.S. person from a voyage between two Canadian ports on the Great Lakes. This right to tax applies even though the profits would not be taxable under the business profits article by the country in which the voyage takes place.

The proposed treaty also contains a special provision dealing with the taxation of income earned by a common carrier from the use of motor vehicles or railway cars. Under the proposed treaty, the profits of a resident of one country from the transportation of passengers or property between a point outside the other country and any other point, or from the rental of motor vehicles (including trailers) or railway rolling stock, or the use, maintenance or rental of containers used to transport passengers or property between a point outside the other country and any other point, are not taxed in the country that is not the country of residence. This provision applies only if the resident earning the income is engaged in the operation of motor vehicles or a railway as a common carrier. Thus, for example, if a U.S. common carrier transports goods from a place in the United States to a Canadian destination, Canada may not tax any of the profits from that delivery.

The proposed treaty also contains a special provision limiting the right of the countries to tax profits from the use of railway rolling stock, motor vehicles or containers. Profits derived by a resident of one country from the use, maintenance or rental of railway rolling stock, motor vehicles, trailers or containers (including trailers and related equipment for the transportation of containers) used in the other country for a period or periods not expected to exceed 183 days in any 12-month period are not taxable in that other country except to the extent the profits are attributable to a permanent establishment in the other country and are liable to tax in that other country by reason of Article VII (Business Profits). Unlike the provision dealing with income from the carriage of passengers or freight, this exemption applies even if the owner is not a common carrier. Thus, for example, Canada would not tax the rental income of a U.S. bank from the short-term (less than 183 days) lease of a railroad car to a Canadian railroad.

Article IX. Related Persons

The proposed treaty, like most other U.S. tax treaties, recognizes the arm's-length pricing principle. The proposed treaty contains a provision similar to section 482 of the Internal Revenue Code which recognizes the right of each country to make an allocation of income to that country in the case of transactions between related enterprises, if an allocation is necessary to reflect the conditions and arrangements which would have been made between independent enterprises. An enterprise in one country is not independent with respect to an enterprise in another country if one of the enterprises participates directly or indirectly in the management or control of the other enterprise. The enterprises are also not independent if the same persons participate directly or indirectly in the management or control of both enterprises.

When a redetermination has been made, or is to be made, by one country, the other country, if it agrees with the adjustment, and if it has been notified of the adjustment within six years from the end of the taxable year to which the adjustment relates, will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income.

The competent authority of the country making the adjustment is not required to advise the competent authority of the other country of the adjustment. If the competent authority of the country making the adjustment does not notify the competent authority of the other country and if the taxpayer does not receive notification of the adjustment six months or more before the six-year period expires, then the first country cannot make the initial adjustment to the extent that making it would give rise to double taxation. The intent of this provision is to place the burden of notifying the other competent authority on the taxpayer, and the burden of giving the taxpayer timely notice (so that he can protect himself) on the competent authority of the country making the initial adjustment. However, one competent authority may notify the other.

The provisions allowing relief if the competent authority originating the adjustment does not make notification do not apply if the adjustment, or the time lag, is due to fraud, willful default or neglect, or gross negligence.

The relief provisions do not require that an adjustment actually have been made or formally proposed. However, the taxpayer must be notified of a possible adjustment in writing with sufficient details to permit the taxpayer to notify the competent authority of the other country. Likewise, the notification to the competent authority of the other country must be in sufficient detail to appraise the competent authority of the nature of the adjustment.

These relief provisions apply notwithstanding the saving clause found in Article XXIX (Miscellaneous Rules). Thus, the United States will give up tax on a resident corporation if it agrees with a Canadian adjustment for a U.S. corporation, or if the United States fails to meet the notice requirements.

Apart from the above procedural limitations, the provisions of the proposed treaty are not intended to limit any law in either country which permits the distribution, apportionment, or allocation of income, deductions, credits or allowances between related persons when such law is necessary to prevent evasion of taxes or to clearly reflect the income of those persons. Thus, the U.S. retains the right to apply its intercompany pricing rules (section 482) and its rules relating to the allocation of deductions (sections 861, 862, and 863, and Treas. Reg. Section 1.861-8).

Article X. Dividends

The United States imposes a 30-percent tax on the gross amount of U.S. source dividends paid to nonresident alien individuals and foreign corporations. The regular graduated rates (and not the 30-percent tax) apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. U.S. source dividends are dividends paid by a U.S. corporation, and dividends paid by a foreign corporation if at least 50 percent of the gross income of the corporation, in the prior three year period, was effectively connected with its U.S. trade or business. The proposed treaty reduces this tax, and also Canadian tax on dividend income.

Under the proposed treaty, each country may tax dividends paid by its resident companies but the rate of tax is limited by the treaty if the beneficial owner of the dividend is a resident of the other country. Source country taxation is limited to 10 percent of the gross amount of the dividends if the beneficial owner is a corporation that owns at least 10 percent of the voting stock of the payor corporation. The tax is limited to 15 percent of the gross amount of the dividend in all other cases involving dividends paid to residents of the other country. For example, under the proposed treaty, Canada could impose a 10-percent tax on gross dividends paid to a U.S. parent corporation by its Canadian subsidiary. Likewise, Canada could impose a 15-percent tax on the gross dividends paid to a U.S. investor by a Canadian company. The 10-percent rate of tax on corporate direct investment dividends represents a reduction from the 15 percent provided for in the present treaty. It is greater than the five-percent rate found in many U.S. treaties and the U.S. model.

The proposed treaty does not restrict the right of a country to tax the profits out of which the dividends are paid. Canada has a modified "integrated" corporate tax system. Under this system, a Canadian resident shareholder (individual or trust) must "gross-up" the dividend he receives from a Canadian corporation by a portion of the amount of tax paid at the corporate level on the distributed income. He is then taxed on the grossed-up amount but may credit a portion of the tax paid by the corporation ("imputation credit"). If the credit is greater than his tax due, he does not get a tax refund. The proposed treaty does not give U.S. shareholders any relief from the corporate tax in the form of a refund or otherwise. Such relief is granted to U.S. shareholders in U.S. income tax treaties with France and the United Kingdom, which also have integrated tax systems. Under those treaties, some U.S. shareholders in a foreign resident company who receive dividends get a partial refund of the corporate income tax paid.

The proposed treaty defines dividends as income from shares or other rights which participate in profits and which are not debt claims. Dividends also include income from other corporate rights which are taxed by the country in which the distributing corporation is resident in the same manner as income from shares. Under this provision, each country may apply its rules for determining when a payment by a resident company is on a debt obligation or an equity interest. Thus, for example, the United States could apply its section 385 rules for determining whether an interest is debt or equity.

The reduced rates of tax on dividends will apply unless the recipient has a permanent establishment (or fixed base in the case of an individual performing independent personal services) in the source country with which the shareholdings are effectively connected. Dividends effectively connected with a permanent establishment are to be taxed on a net basis as business profits (Article VII). Dividends effectively connected with a fixed base are to be taxed on a net basis as income from the performance of independent personal services (Article XIV).

The proposed treaty would limit the right of one of the countries to tax dividends paid by a corporation resident in the other country. The country in which the corporation is not resident may tax dividends paid by the corporation only if they are paid to a resident of that country or if the equity interest with respect to which the dividends are paid is effectively connected with a permanent establishment or fixed base maintained in that country.

A country may, however, tax dividends paid by a corporation resident in the other country if at least 50 percent of the corporation's gross income for the past three years was included in the computation of the business profits of a permanent establishment that the corporation had in the other country. This applies only if the country imposing the tax does not impose a branch profits tax. The rate of tax on the dividend is limited to the rates provided by the proposed treaty if the dividend is paid to a resident of the other country. The provision is intended to allow imposition of the withholding tax the United States imposes on dividend payments by foreign corporations most of whose income is effectively connected with a U.S. business. Canada does not impose such a tax but imposes a branch profits tax instead.

The proposed treaty would also reserve the right of the United States or Canada to impose a tax in addition to the regular corporate tax imposed on that permanent establishment on the earnings of a permanent establishment maintained there. The rate of tax is limited to 10 percent of the earnings not previously subject to an additional tax. The purpose of this provision is to permit Canada, subject to special limitations, to continue to impose its branch profits tax. The Canadian tax of 25 percent is imposed on the profits of a Canadian branch of a foreign corporation remaining after imposition of the regular corporate tax and after reinvestment in Canada is taken into account. Canada generally reduces this tax rate to 15 percent in treaties. The proposed treaty would reduce the rate to 10 percent and give the $500,000 exclusion described below. The United States does not impose such a tax.

The amount of earnings that may be taxed under this provision is the excess of business profits attributable to all a company's permanent establishments in the taxing country for the year or previous years over the sum of: (a) business losses attributable to such permanent establishments (including losses from the alienation of property forming part of the business property of such permanent establishments) for such year and previous years; (b) all taxes, other than the branch profits tax, imposed on such profits in that country (including, for example, provincial taxes); (c) profits reinvested in that country, provided that where that country is Canada, such amount shall be determined in accordance with the existing provisions of the law of Canada regarding the computation of the allowance in respect to investment in property in Canada (and any subsequent modification of those provisions which does not affect their general principle); and (d) five hundred thousand Canadian dollars ($500,000) or its equivalent in United States currency, less any amounts deducted by the company, or by an associated company with respect to the same or a similar business, under this rule.

The $500,000 amount is cumulative. Thus, in effect, a country cannot impose a branch profits tax on the earnings of a permanent establishment under this provision until it has earned $500,000 after the proposed treaty becomes effective. The exclusion is available to permanent establishments that have earnings before the treaty is effective. Thus, even existing permanent establishments in Canada will qualify for the exemption on their first $500,000 in earnings after the effective date of the provision.

The proposed treaty would preserve the right of the United States to impose its accumulated earnings tax and personal holding company tax, but only if at least 50 percent or more in value of the outstanding voting stock of the company is owned, directly or indirectly, throughout the last half of the taxable year by U.S. citizens or residents or by third country residents. Canadian citizens who are not immigrants in the United States and who have not been United States residents for more than three taxable years are not considered to be residents of the United States for this purpose.

The provisions of Article X do not apply to dividends paid by a corporation that is not a resident of the United States or Canada. Those dividends are covered by Article XXII (Other Income) if they are income of a resident of one of the countries.

Article XI. Interest

The U.S. imposes a 30-percent tax on U.S. source interest paid to foreign persons under the same rules that apply to dividends. Under the Code, U.S. source interest generally is interest on debt obligations of U.S. persons, but not interest on deposits in banks. U.S. source interest also includes interest paid by a foreign corporation if at least 50 percent of the gross income of the foreign corporation, in the prior three year period, was effectively connected with a U.S. trade or business of that corporation.

Under the proposed treaty, interest may be taxed by a country only if the beneficial owner of the interest is a resident of that country, the interest arose in that country, or the debt claim to which the interest relates is effectively connected with a permanent establishment or fixed base in that country. The proposed treaty limits the withholding tax to 15 percent generally and exempts interest payments to exempt governmental organizations of the other country. The 15 percent rate is the same as that allowed by the present treaty. The limitation applies only if the interest is beneficially owned by a resident of the other country. Accordingly, it does not apply if the recipient is a nominee for a nonresident.

Interest will be exempt from tax at source in certain cases. These include where the beneficial owner is a political subdivision, local authority or instrumentality of the other country and not subject to tax in that country; the interest is beneficially owned by a resident of the other country and the debt obligation is guaranteed or insured by the other country, a tax-exempt political subdivision of it or the like; the interest is beneficially owned by a resident of the other country and paid by the source country, a tax-exempt political subdivision or local authority or instrumentality thereof; the interest is on a commercial credit obligation and is beneficially owned by an unrelated seller resident in the other country; or the interest is exempt under the present treaty and paid by a company organized under the laws of either country on debt obligations entered into before September 26, 1980, the date the proposed treaty was signed.

An obligation is considered entered into before the date of signature of the proposed treaty if it is: (1) an obligation under which funds were disbursed prior to September 26, 1980; (2) an obligation under which funds are disbursed on or after September 26, 1980, pursuant to a written contract binding prior to and on such date, and at all times thereafter until the obligation is satisfied; or (3) an obligation with respect to which, prior to September 26, 1980, a lender had taken every action to signify approval under procedures ordinarily employed by such lender in similar transactions and had sent or deposited for delivery to the person to whom the loan is to be made written evidence of such approval in the form of a document setting forth, or referring to a document sent by the person to whom the loan is to be made that sets forth, the principal terms of such loan. The present treaty contains a limited exemption from tax for interest paid by corporations resident in Canada or the United States to certain persons not resident in the other country.

The proposed treaty defines interest as income from debt claims of every kind, whether or not secured and whether or not carrying a right to participate in profits. In particular, it includes income from government securities and from bonds or debentures. The impact of this provision on U.S. domestic rules (e.g., section 385) for distinguishing between debt and equity is made clear. The provision is intended to permit the United States to apply its rules with the competent authorities settling disputes if this causes double taxation.

The reduction in the withholding tax will not apply if the recipient has a permanent establishment or fixed base in the source country and the debt claim is effectively connected with the permanent establishment or fixed base. In that event, the interest will be taxed as business profits (Article VII) or income from the performance of independent personal services (Article XIV).

The proposed treaty provides a source rule for interest (which is also used in Article XXIV (Elimination of Double Taxation)) for foreign tax credit purposes. Interest will have its source within a country if the payor is the government of that country, including political subdivisions and local authorities, or a resident of that country. Generally, this is consistent with U.S. source rules (sections 861-862) which say that interest income has its source in the country in which the payor is resident. However, if the interest is borne by a permanent establishment (or fixed base) that the payor has in a country other than his country of residence and the indebtedness was incurred with respect to that permanent establishment (or fixed base), the interest will have its source in that country, regardless of the residence of the payor. Thus, for example, if a Canadian resident has a permanent establishment in France and the Canadian resident incurs indebtedness to a U.S. person for the French permanent establishment, and that permanent establishment bears the interest on that indebtedness, Canada will not tax the interest.

The proposed treaty also addresses the issue of non-arm's-length interest charges between related parties (or parties having an otherwise special relationship) by holding that the amount of interest for purposes of applying the treaty rules will be the amount of arm's-length interest. Any amount of interest paid in excess of the arm's-length interest will be taxable according to the laws of each country, taking into account the other provisions of this treaty. For example, excess interest paid to a parent corporation may be treated as a dividend under local law and thus be entitled to the benefits of Article X of this treaty.

As described above, under U.S. law certain interest paid by foreign corporations doing business in the United States is considered U.S. source and is thus subject to the 30-percent withholding tax. The proposed treaty restricts the right of the United States to apply this tax to the interest that a Canadian company pays to a person not a resident of the United States. Under the existing treaty the United States cannot impose this tax at all. Under the proposed treaty, one country will not tax interest paid by a resident of the other country, unless the interest is paid to a resident of the first country or has its source in that first country under the treaty or the debt-claim on which the interest is paid is effectively connected with a permanent establishment or fixed base in the first country.

Article XII. Royalties

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax on U.S. source royalties paid to foreign persons. Royalties are from U.S. sources if they are from property located in the United States. U.S. source royalties include royalties for the use of or the right to use intangibles (including moving pictures) in the United States.

The proposed treaty provides for a reduction of source basis taxation, but differs from U.S. and OECD models by providing separate rules for taxation at source of cultural royalties and all other royalties. Cultural royalties are exempt from tax by the country of source while other royalties are not.

Royalties, other than cultural royalties, that arise (under the royalty source rule discussed below) in one country and are paid to a resident of the other country may be taxed by both countries. However, the withholding tax imposed in the source country may not exceed 10 percent of the gross royalty.

Cultural royalties generally include copyright royalties and other like payments for the production or reproduction of any literary, dramatic, musical or artistic work arising in one country and beneficially owned by a resident of the other. Royalties for motion pictures and works on film, videotape, or other means of reproduction for use in connection with television are not cultural royalties, but instead are other royalties. Thus, motion picture royalties could be taxed at 10 percent of the gross payment. Article V of the proposed first protocol makes it clear that royalties for works for use in connection with television are not cultural royalties whether or not the works appear on film or videotape.

Royalties are generally defined as payments for the use of, or the right to use, any copyright of literary, artistic, or scientific work (including motion pictures and works on film, videotape, or other means of reproduction for use in connection with television), patents, trademarks, designs, models, plans, secret processes or formulae, tangible personal property or other similar property or rights. Article V of the proposed first protocol makes it clear that payments for works for use in connection with television are royalties whether or not the works appear on film or videotape. Royalties also include payments for scientific, technical, industrial or commercial knowledge or information ("know-how") held by the person supplying the know-how, including ancillary and subsidiary assistance with respect to the know-how, and payments for the use of, or the right to use tangible personal property. Finally, gains from the sale or other disposition of these properties or rights will be considered to be royalties to the extent that the payment of the sale price is contingent on the productivity, use or subsequent disposition of the property or rights.

The reduced withholding tax rate or exemption does not apply where the recipient is an enterprise with a permanent establishment in the source country or an individual performing personal services in an independent capacity through a fixed base in the source country, and the property giving rise to the royalties is effectively connected with the permanent establishment or fixed base. In that event the royalties will be taxed as business profits (Article VII) or income from the performance of independent personal services (Article XIV).

The proposed treaty provides special source rules for royalties. The general rule in the proposed treaty is the same as the U.S. Code rule; that is, if the property or rights which are the subject of the royalty are used in one of the countries then the royalty is sourced in that country. The proposed first protocol makes a technical clarification to this general source rule for royalties. The proposed first protocol makes it clear that this general rule applies to payments for the right to use property in one of the countries as well as payments for the actual use of property. If the property is not used in one of the countries and the person paying the royalties has a permanent establishment or fixed base in a country other than the country of which he is a resident then if the obligation to pay the royalty was incurred in connection with, and the royalties are borne by, the permanent establishment or fixed base, the royalties arise in the country in which the permanent establishment or fixed base is situated.

If a royalty is paid by the government of one of the countries, including political subdivisions and local authorities, or by a resident of that country, and if the property is used in a third country then the income will be sourced in the country of residence of the payor.

The proposed treaty provides that in the case of royalty payments between related parties or persons otherwise having a special relationship, only that portion of the payment that represents an arm's-length royalty will be treated as a royalty under the treaty. Payments in excess of the arm's-length amount will be taxable according to the law of each country with due regard being given for the other provisions of the treaty. Thus, for example, any excess amount might be treated as a dividend subject to the taxing limitations of Article X.

The proposed treaty provides that one country may not tax royalties paid by a resident of the other country unless they are paid to a resident of that first country, arise in it or are effectively connected with a permanent establishment or fixed base there.

Article XIII. Gains

Under the Code, capital gains derived from U.S. sources by foreign investors are generally exempt from U.S. tax. Special rules are provided for a disposition of a U.S. real property interest. The present treaty contains a broad exemption for capital gains which is significantly cut back by the proposed treaty. The proposed treaty also deals with problems created by the Canadian departure tax.

Under the language of the proposed treaty gains derived by a resident of one country from the disposition of real property located in the other country may be taxed by both countries. Gains from the disposition of personal property which forms a part of the business property of a permanent establishment or a fixed base (including gains on the disposition of the permanent establishment or the fixed base itself) may be taxed in the country where the permanent establishment or fixed base is located. For this purpose a permanent establishment includes a permanent establishment that existed within the last 12 months prior to the disposition of the property. This rule does not apply to gains from the sale or exchange of ships, aircraft or containers operated by an enterprise of the other country in international traffic; such gains are taxable by only the country of residence under Article VIII.

Gains from the disposition of intangible property described in Article XII (Royalties) will be taxed only in accordance with that article

As stated above, the proposed treaty contains language that would permit a country to tax a resident of the other country when he disposes of real property located in the first country. For example, the United States could tax a Canadian resident on any gain realized when he sells U.S. real estate. Before amendment by the proposed first protocol, the proposed treaty provided that a country could generally tax gains on the disposition of stock or on the disposition of an interest in a partnership, trust, or estate only if the value of the interest was derived principally from real estate located in that country. The proposed first protocol retains this rule for real property located in Canada. The United States, however, imposes tax when a foreign investor disposes of an interest in a partnership, trust, or estate to the extent that any gain is attributable to U.S. real property interests, whether or not the value of the interest was derived principally from U.S. real property. The proposed first protocol conforms the proposed treaty to U.S. law in this respect. The proposed first protocol defines real property situated in the United States to mean a U.S. real property interest and real property within the meaning of that term under Article VI of the proposed treaty, as amended (which includes real property as defined under U.S. tax laws), that is situated in the United States.

The proposed treaty as amended by the proposed first protocol specifies that real property for the purpose of Canadian source basis taxation of gains includes real property within the meaning of that term under Article VI of the proposed treaty, as amended (which includes real property as defined under Canadian tax laws), that is situated in Canada. The term also includes shares in a company or an interest in a partnership, trust, or estate if the value of the shares or the interest is derived principally from real estate located in Canada.

Under the proposed treaty (before amendment by the proposed first protocol), a country could have taxed dispositions of stock by a resident of the other country only if the resident and related persons owned 10 percent or more of the shares of any class of the company's capital stock. The proposed first protocol removes this restriction, so that a country may impose tax on disposition of stock by a resident of the other country whether or not the resident and related persons own a substantial interest in the company. The intent is to permit the United States or Canada to tax the gain on the disposition of real property even if held in corporate solution or otherwise.

Under the proposed treaty before amendment by the proposed first protocol, a country could have taxed the disposition of stock or the disposition of an interest in a partnership, trust, or estate by a resident of the other country only if that other country imposed a comparable tax. U.S. law imposes a tax on a foreign investor who disposes of a U.S. real property interest whether or not the foreign investor's country taxes comparable U.S. persons. The proposed first protocol conforms the proposed treaty to U.S. law by removing this prerequisite (of comparable foreign law) to source country taxation.

Before amendment by the proposed first protocol, the proposed treaty would not have allowed source country taxation of certain real property in which the business of a company, partnership, trust, or estate was carried on. The proposed first protocol removes this restriction on source country taxation. Thus, the source country may impose tax on disposition of a real property interest whether or not the foreign taxpayer carried on business in the real property underlying that interest.

Gains from the disposition of property other than that described above may be taxed only by the country of residence of the person disposing of the property.

The proposed treaty would preserve Canada's right to impose its "departure tax" on the disposition of Canadian property by a former Canadian resident. Before amendment by the proposed first protocol, the proposed treaty provided that a country can tax the gain realized by an individual resident of the other country if that individual was a resident of the taxing country both for 120 months during any period of 20 years and at any time during the ten years immediately preceding the disposition of the property. The proposed first protocol clarifies Canada's right to impose this departure tax on disposition of Canadian property by a former Canadian resident. Under the proposed treaty as amended, a country can tax the gain realized by an individual resident of the other country if that individual was a resident of the taxing country both for 120 months during any period of 20 consecutive years preceding the alienation of the property and at any time during the ten years immediately preceding the disposition of the property, but only if the individual owned the alienated property (or substituted basis property) when he ceased residence in the taxing country. Accordingly, Canada could tax a U.S. resident on his disposition of personal property in these circumstances.

However, gains that are taxable by one country under this provision have their source for treaty purposes in the country of residence (Article XXIV of the proposed treaty). Thus, the country of residence will have the primary right to tax the gain, while the country of former residence will allow a foreign tax credit for the tax paid to the country of residence.

The proposed treaty also contains a provision that provides for a step-up in the basis of a principal residence in Canada when a Canadian resident moves to the United States. The adjusted basis of the real estate for purposes of determining any U.S. gain on the disposition of the Canadian residence will be no less than its fair market value at the time the individual ceased being a resident of Canada. The rules does not apply to a U.S. citizen. The rule applies to dispositions after the treaty becomes effective even if the individual became a nonresident of Canada before that date.

The proposed treaty gives an individual the right to elect to be taxed on certain deemed gain inherent in the property. This provision applies where one of the countries treats an individual as having disposed of property and taxes him on that deemed disposition, while the other country defers (but does not forgive) taxation. In such a case, the proposed treaty provides that the individual may elect to be liable to tax in that other country on the difference between his basis and the fair market value of the property at the time of disposition. The individual then gets a basis in the property equal to that fair market value. The provision is intended to permit a Canadian resident who is a U.S. citizen and who immigrates to the United States and incurs the Canadian departure tax to have that property taxed by the United States also in that year. He could then credit the Canadian tax against his U.S. tax, avoiding double taxation. Likewise, the provision could apply in the case of a gift by a U.S. citizen or resident because Canada considers a gift to be a recognition event while the United States imposes no income tax at the time of the gift but generally assigns to the recipient the donor's basis.

The proposed treaty also provides special rules for corporate reorganization transactions. Where a resident of one country disposes of property in a nonrecognition transaction, the competent authority of the other country may, upon request, agree to defer recognition of gain on the transaction until such time and in such manner as may be provided in an agreement between the taxpayer and the competent authority. Deferral, if permitted, is to be permitted in order to avoid double taxation and subject to terms and conditions satisfactory to the competent authority.

The present convention generally exempts capital gains from tax at source, while the proposed convention does not. The proposed convention contains a transitional rule that takes this difference into account. In general, the transitional rule applies to certain property that was owned by a resident of the nonsource country on September 26, 1980 (the date of signature) and which was not part of a permanent establishment or fixed base in the source country.

The effect of the transitional rule is to give the owner of the property a step-up in basis for purposes of computing gain computed as provided in the proposed treaty. Under the transitional rule, for purposes of computing source basis taxation on the gain from the disposition of property, the gain realized on a disposition is to be reduced by the proportion of any gain attributable to the period the property was held by the person disposing of the property up to December 31 of the year in which the instruments of ratification are exchanged. This method gives taxpayers the benefit of the assumption that capital assets that appreciate do so in the same amount during each month of the holding period. If, however, the taxpayer shows to the satisfaction of the competent authority of the source country that a greater than proportional part of the gain is reasonably attributable to that period, then the competent authority is to permit that greater portion to be excluded from tax.

The proposed first protocol restricts the application of the transition rule. Before amendment by the proposed first protocol, the transition rule would have applied to any resident of one country who alienated property subject to source basis taxation in the other country, so long as the property belonged on September 26, 1980 (the date of signature of the proposed treaty) to a resident of the same country as the person alienating the property. The proposed first protocol allows application of the transition rule only if the resident who alienates the capital asset both owned it on September 26, 1980 and resided in the same country on September 26, 1980, or if the resident who alienates the asset acquired the asset in an alienation of property that qualified as a nonrecognition transaction for purposes of taxation in the source country.

The proposed first protocol defines "nonrecognition transaction" for this purpose to include alienation of property in the course of a corporate organization, reorganization, amalgamation, division or similar transaction with respect to which gain is not recognized for tax purposes in the country of the residence of the alienator, and tax on which is deferred in the other country (pursuant to the proposed treaty) under an agreement with that other country's competent authority. The term includes a transaction that would have been a nonrecognition transaction but for section 897(d) of the Internal Revenue Code, which overrides nonrecognition treatment in the case of certain distributions by foreign corporations of U.S. real property interests. The term also includes a transaction that would have been a nonrecognition transaction but for section 897(e) of the Internal Revenue Code, which overrides nonrecognition treatment in the case of the exchange of a U.S. real property interest for an interest the sale of which would not be subject to U.S. tax.

The transition rule specifically does not apply, however, to three kinds of transactions. First, it does not apply to alienation of an asset that, on September 26, 1980, formed part of the business property of a permanent establishment (or pertained to a fixed base) of a resident of one of the countries that was situated in the other country. Second, it does not apply to an alienation by a resident of one country of an asset that was owned at any time after September 26, 1980, and before that alienation, by a person who was not at all times after September 26, 1980 (and while he owned the asset) a resident of that country. Third, it does not apply to an alienation of an asset that was acquired between September 26, 1980 and the time of the alienation in a transaction other than a nonrecognition transaction.

Article XIV. Independent Personal Services

Under the Code, the income of a nonresident alien from the performance of personal services in the United States is not taxed if the individual is not in the United States for at least 90 days, the compensation does not exceed $3,000, and the services are performed as an employee of a foreign person not engaged in a trade or business in the United States or they are performed for a foreign permanent establishment of a U.S. person. His income is taxed at regular rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article VII (Business Profits).) The performance of personal services within the United States can be a trade or business within the United States (sec. 864(b)).

The present treaty provides a limited exemption from tax at source, and has a $5,000 threshold for source taxation even where the services are performed through a fixed based in the source country.

The proposed treaty limits the right of a country to tax income from the performance of personal services by a resident of the other country. Income from the performance of independent personal services is treated separately from income from the performance of dependent personal services (i.e., as an employee).

Income from the performance of independent personal services by a resident of one country may be taxed by the other country only where the individual performing the personal services has or had a fixed base available to him in the other country. The income is then taxable in that other country only to the extent attributable to that fixed base.

Article XV. Dependent Personal Services

Under the proposed treaty, income from services performed as an employee in one country (the source country) by a resident of the other country will not be taxable in the source country and will be taxable only in the country of residence unless: (1) the individual's remuneration exceeds $10,000 in the source country's currency, or (2) the individual is present in the source country for more than 183 days during the taxable year or (3) the compensation is borne by a permanent establishment or fixed base or a resident of the source country.

Compensation derived by an employee aboard a ship, aircraft, motor vehicle or train operated by a resident of one country is exempt from tax by the other country, provided that the compensation is in respect of employment regularly exercised in more than one country.

The article does not apply to pensions and annuities (Article XVIII) or to compensation as a government employee (Article XIX).

Article XVI. Entertainers and Athletes

The proposed treaty contains an additional set of rules which govern the taxation of income earned by public entertainers or "artistes" (such as theater, motion picture, radio or television entertainers and musicians) and athletes. These rules, in this proposed article, apply notwithstanding the other provisions dealing with the taxation of personal services (Articles XIV and XV). Under the proposed Article, one country may tax an entertainer or athlete who is a resident of the other country on the income from his personal services performed in that country during any year in which the gross receipts derived by him, including his reimbursed expenses, exceed $15,000 in the currency of the source country. As in the case of the other provisions dealing with personal services income, this provision does not bar the country of residence or, or in the case of the United States, citizenship from also taxing that income (subject to a foreign tax credit).

In addition, the proposed treaty provides that where income in respect of personal services performed by an entertainer or athlete is paid not to the entertainer or athlete but rather to another person or entity, that income will be taxable by the country in which the services are performed in any situation where the entertainer or athlete shares directly or indirectly in the profits of the person or entity receiving the income. (This provision applies notwithstanding Articles VII, XIV and XV.) For this purpose, participation in the profits of the recipient of the income includes the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions, or other distributions. The provision does not apply if it is established that neither the entertainer or athlete, nor related persons, participate directly or indirectly in the profits of the person or entity receiving the income in any manner. This provision is intended to prevent highly paid performers and athletes from avoiding tax in the country in which they perform by routing the compensation for their services through a third person such as a personal holding company or trust located in a country that would not tax the income. Arguably, before amendment by Article

VII of the proposed first protocol, this rule would have applied to incentive payments that a team made to a player on the basis of performance or attendance at games in the source country. The proposed first protocol makes it clear that the proposed treaty, as amended, will not apply in such a case.

These provisions do not apply to the income of an athlete earned as an employee of a team that participates in a league with regularly scheduled games in both Canada and the United States. The dependent personal services rules of Article XV would apply.

The proposed first protocol adds a new rule governing any payment (other than salaries, wages, or similar remuneration) as an inducement to sign an agreement relating to the performance of the services of an athlete. In the case of such a payment (sometimes called a "bonus" payment) by a resident of one country to a resident of the other country, the payor's country may tax that payment, but that tax may not exceed 15 percent of the gross amount of the payment. Without this rule in the first protocol, the extent of the authority of the country of the payor to tax these payments would be unclear.

Article XVII. Withholding of Taxes in Respect of Personal Services

Under the proposed treaty a country may impose a withholding tax at source on remuneration paid to a resident of the other country who performs independent personal services in the source country. However, in the case of the first $5,000 paid for independent personal services during the year, the withholding is limited to 10 percent of the payment. This provision in no way limits taxation of income or an individual's tax liability.

Under the proposed treaty before amendment by Article VIII of the proposed first protocol, if a resident of one country earned income from independent personal services in the other country, the competent authority of the source country had the discretion to reduce the rate of withholding of income tax at the source. The proposed first protocol allows the competent authority to reduce the rate of withholding of income tax at the source on payments to residents of the other country for any personal services—not just independent personal services—performed in the source country. Therefore, the competent authority could reduce the withholding rate on income from employment. Absent this provision in the proposed first protocol, no relief from statutory withholding might be available. The proposed first protocol also amends the title of this article to indicate that it covers more than independent personal services.

Article XVIII. Pensions and Annuities

As a general rule, the proposed treaty provides that a pension or annuity may be taxed in both the country where it arises (source country) and the country of residence of the recipient. Before amendment by Article IX of the proposed first protocol, the proposed treaty limited the amount of pension payments taxable in the country of residence to the amount that would have been included in income in the source country had the recipient been a resident of the source country. The proposed first protocol instead provides that the country of residence must exempt from tax the amount of any such pension that would be excluded from taxable income in the source country if the recipient were a resident of the source country. Thus, the proposed first protocol makes it clear that the residence country need not take into account personal exemptions or similar provisions in the source country.

Source country taxation of pensions and annuities beneficially owned by a resident of the other country is limited. Pensions may be taxed at 15 percent of the gross amount of the payment. The proposed first protocol clarifies the limitation on source country taxation of annuities beneficially owned by a resident of the other country. That tax on annuities, before amendment by the proposed first protocol, was limited to 15 percent of the portion of the payment that was liable to tax in the source country. The proposed first protocol instead limits the source country tax to 15 percent of the portion of the payment that would not be excluded from taxable income in the source country if the recipient resided there. The purpose of this change is to make it clear that the source country need not take into account personal exemptions or similar provisions in its tax laws in imposing its gross 15-percent tax.

Alimony and other similar amounts (including child support payments) that have their source in one country and are paid to a resident of the other country are generally taxable only in the residence country, but the residence country must exempt from taxation the amount that the source country would exclude if the recipient resided in the source country. (This rule is subject to the saving clause, which could allow, for example, the United States to tax U.S. citizens who are Canadian residents on the receipt of alimony.) The proposed first protocol clarifies the treatment of alimony and child support payments by requiring the residence country to exempt this amount. The proposed treaty before amendment limited the amount residence country could include in income. This change makes it clear that the residence country need not consider personal exemptions and similar provisions.

Under the proposed treaty (before amendment by the proposed first protocol), pensions and annuities, alimony and similar payments were excluded from the saving clause as applied to U.S. taxation of U.S. citizens resident in Canada. The proposed first protocol makes it clear that a country retains the right to tax pension payments, annuity payments, and alimony and other similar amounts (including child support payments) on the basis of residence or citizenship of the recipient.

A pension is defined to include a payment under a superannuation, pension or retirement plan, Armed Forces retirement pay, war veterans pensions and allowances, and amounts paid under a sickness, accident or disability plan. Social security payments are not pensions. An annuity is defined to include a stated sum paid periodically at stated times during life or a specified number of years, under an obligation to make the payments for full and adequate consideration. The term does not include a payment that is not a periodic payment or any annuity the cost of which was deductible in the country in which acquired.

Before amendment by the proposed second protocol, the proposed treaty provided that social security benefits paid to a resident of the other country or to a U.S. citizen would be taxable only by the source country. In 1983, Congress imposed tax on some social security payments. Social Security payments to nonresident aliens are generally subject to a withholding tax at an effective 15-percent rate. The proposed second protocol provides that social security benefits paid to a resident of the other country are taxable only in the residence country. The saving clause applies to this provision, so that the United States may tax U.S. social security payments made to Canadian residents who are U.S. citizens. However, Canadian residents who are not U.S. citizens will not be subject to U.S. tax on U.S. social security benefits. The proposed first protocol provides, in addition, that one-half of social security benefits are exempt from residence country tax. The saving clause does not apply to this latter provision, so that Canada may tax only one-half of U.S. social security benefits received by Canadian residents.

Article XIX. Government Service

Under the proposed treaty, compensation paid by one country, its political subdivisions or local authorities, to one of its citizens for services rendered in the discharge of governmental functions is taxable only by the paying country. This rule does not apply if the services are rendered in connection with a trade or business carried on by the country or one of its political subdivisions or local authorities. Those services would be taxable in accordance with Article XIV (Independent Personal Services), XV (Dependent Personal Services) or XVI (Artists and Athletes), as appropriate. This provision is excluded from the saving clause. Thus, for example, Canada would not tax the compensation of a U.S. citizen who resides in Canada and performs services for the U.S. government in the discharge of functions of a government nature.

Article XX. Students

Under the proposed treaty, an individual who was a resident of one country who becomes a full-time student, apprentice, or business trainee in the other country will generally be exempt from tax in the host country on payments from abroad used for maintenance, education, or training. There is no limitation on the amount of income to which the exemption applies or the number of years the student may take advantage of the exemption.

The present treaty (Article VIII A) contains a two-year exemption by the source country of income paid a teacher who is a resident of the other country. The proposed treaty does not contain any special rules for teachers; accordingly, they would be covered by the Articles relating to personal services generally (Articles XIV and XV).

Article XXI. Exempt Organizations

The proposed treaty contains a number of provisions that permit an entity that is exempt from tax in one country to be tax exempt in the other country. Also, citizens and residents of one country may, subject to limitations, receive a charitable contribution deduction for contributions to entities resident in the other country. The present treaty contains similar provisions in Articles X and XIII D, but they do not exempt pension plans.

Exemptions for charities and pensions.—Under the proposed treaty, a religious, scientific, literary, educational or charitable organization ("exempt organization") resident in one country is exempt from tax in the other country to the extent its income is exempt from tax in its country of residence. This exemption does not apply to income of the exempt organization received for carrying on a trade or business or received from a related person unless that person is also a charitable organization, or is a pension plan.

The provision contemplates that a determination will be made that an organization is or is not charitable. A note exchanged at the signing of the proposed treaty states that the competent authorities will review the procedures of the other country for deciding whether an organization is charitable to determine whether they are similar to their own procedures. If they are, the competent authority will accept the certification of the organization by the other competent authority and not require an organization to qualify in both countries. Under U.S. law, charities often have to file an application for exempt status and obtain a ruling from the Internal Revenue Service to the effect that they meet the requirements for exempt status (section 501(c)(3)). In the absence of this note, it is anticipated that a Canadian organization would have to go through that process in order to qualify as a charitable organization to which U.S. persons could donate deductible amounts.

The proposed treaty provides an exemption from source country taxation of dividends and interest paid to an organization that is (1) resident in one of the countries, (2) generally exempt from tax in a taxable year in the country of its residence, and (3) constituted and operated exclusively to administer or provide benefits under one or more funds or plans established to provide pension, retirement or other employee benefits (an "employee benefit organization"). The proposed first protocol extends this exemption to a trust, company, or other organization resident in one of the countries that is not taxed during the taxable year by the country of its residence and that is constituted and operated exclusively to earn income for the benefit of such an employee benefit organization.

These exemptions do not apply to income from carrying on a trade or business by the exempt organization or the pension plan or from a related person unless that person is an exempt organization or a pension plan.

Excise tax on private foundations.—An exemption from the U.S. excise tax on private foundations is provided a Canadian resident exempt organization that receives substantially all of its support from persons who are not U.S. citizens or residents.

Deductions for charitable contributions.—The proposed treaty provides that a citizen or resident of the United States can take a charitable contribution deduction for certain contributions to certain Canadian charities and vice-versa. Under the proposed treaty, a U.S. citizen or resident can deduct contributions to a Canadian resident organization that is exempt from tax in Canada and that would qualify in the United States to receive deductible contributions if it were resident in the United States. The amount of the deduction is limited to the percentage limitations of U.S. law applied to the donor's Canadian income, and is further limited so that the donor's total contribution for the year cannot exceed the U.S.

statutory limitations. For example, under U.S. law, an individual can deduct contributions to certain charitable organizations up to 50 percent of his income for the year. Under the proposed treaty, a U.S. citizen could deduct amounts paid to a Canadian charity that would qualify as a 50 percent charity if it were a resident of the United States, but only up to 50 percent of his Canadian income. The limitation based on Canadian income does not apply to a contribution by a U.S. person to a Canadian college or university attended by the donor or a member of his family. Similar rules apply to donations by Canadian residents to U.S. charities.

Article XXII. Other Income

As a general rule, items of income not otherwise dealt with in the proposed treaty which are derived by residents of either country shall be taxable only by the country of residence. However, if the income is sourced in the other country, it may also be taxed by that country. The source of an item of income is determined under the domestic laws of the two countries unless the treaty contains a rule. This provision, for example, gives the United States the sole right to tax income sourced in a third country and paid to a resident of the United States.

Income distributed by an estate or trust to a resident of the other country that is not dealt with elsewhere in the treaty may be taxed in the country of residence of the estate or trust if the income is from sources within that country. However, the tax is limited to 15 percent of the gross amount of the income. Accordingly, Canada can tax distributions of income by a Canadian resident estate to a U.S. resident out of income arising in Canada, but the rate of tax cannot exceed 15 percent of the gross amount of the distribution. This provision does not affect U.S. estates.

Article XXIII. Taxes on Capital

Many countries impose a tax on capital in addition to imposing a tax on income. As a general rule, capital taxes are imposed when the income from the capital would be taxed by the other country imposing the capital tax. Neither the United States nor Canada currently imposes a capital tax. However, under Article II (Taxes Covered), such a tax would be covered by the treaty if later enacted by one of the countries. The rules in Article XXIII would then apply to that tax.

Under the proposed treaty, capital could be taxed by the country in which located if it is real property or personal property forming part of the business property of a permanent establishment or fixed base maintained by a resident of the other country. The owner's country of residence could also tax that property. The country of residence would have the exclusive right to tax ships and aircraft and related personal property operated by a resident in international traffic. All other elements of capital could also be taxed only by the country of residence.

Article XXIV. Relief from Double Taxation

Background

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. The United States seeks unilaterally to mitigate double taxation by allowing U.S. taxpayers to credit the foreign income taxes that they pay 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 on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that insures that the foreign tax credit offsets only U.S. tax on foreign source income. This limitation is computed on a worldwide consolidated basis ("overall limitation"). Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. Separate limitations on the foreign tax credit are provided for certain interest and DISC dividends, and special rules apply to certain oil and gas income.

A U.S. corporation that owns 10 percent or more of the stock of a foreign corporation may credit foreign taxes paid or deemed paid by that foreign corporation on earnings that U.S. corporation receives as dividends (deemed paid credit). These deemed paid taxes are included in the U.S. shareholder's total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credited.

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated a a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem was dealt with in previous articles that limited the right of a source country to tax income, and that coordinated the source rules. This article provides further relief where both Canada and the United States would still tax the same item of income.

The present treaty provides for relief from double taxation by each country permitting a credit against its tax for the appropriate amount of taxes paid to the other country on income from sources within that other country. The credit is provided, however, only to the extent permitted under domestic law.

The proposed treaty provides separate rules for relief of double taxation by the United States and Canada. In addition, it provides special rules covering U.S. citizens resident in Canada.

United States

The proposed treaty contains the provision found in many U.S. income tax treaties that the United States will allow a citizen or resident a foreign tax credit for income taxes paid or accrued to Canada. The credit is to be computed in accordance with the provisions of and subject to the limitations of U.S. law. The credit is allowed to certain Canadian companies that have elected to be treated as domestic U.S. companies for purposes of being included in a consolidated return of a U.S. group of corporations (this election is permitted by section 1504(d)).

Before amendment by the proposed first protocol, the proposed treaty limited the credit to the proportion of the U.S. tax that taxable income arising in Canada bore to the taxpayer's entire taxable income. This additional per-country limitation would have applied only if the taxpayer were claiming benefits under the treaty not available under the Code; for example, claiming a credit for a Canadian tax not creditable under the code. The proposed first protocol removes the per-country limitation. Any Canadian taxes creditable under the treaty will be creditable under the overall limitation. Thus, those taxes may offset U.S. tax on income from Canadian sources or from sources without the United States other than Canada.

The proposed treaty also allows the U.S. indirect credit (section 902) to U.S. corporate shareholders of Canadian corporations receiving dividends from those corporations if the U.S. company owns 10 percent or more of the voting stock of the Canadian corporation. The credit is allowed for Canadian income taxes paid by the Canadian corporation on the profits out of which the dividends are paid.

The proposed treaty allows a foreign tax credit for Canada's general corporate tax even though Canada has imposed a flat rate tax on natural resource income that is not deductible in computing the general corporate tax. (This flat rate natural resource royalty tax is not creditable under the proposed treaty.) Canada now imposes this natural resource royalty tax at an effective 12-percent rate. The United States would not be obligated to credit the Canadian general corporate tax imposed on income subject to the natural resource royalty tax if Canada raised its natural resource royalty tax so as to make the general corporate tax not substantially similar to the existing tax.

Canada

Canada will allow a credit against Canadian tax for income taxes paid to the United States on income arising in the United States. This credit is available subject to the provisions of Canadian law relating to the foreign tax credit, as they may be modified. If Canadian law provides a greater deduction or relief, then the taxpayer may use Canadian rules.

Relief from double taxation is provided a corporation resident in Canada by permitting it to deduct any dividends received by it out of exempt surplus of a foreign affiliate which is resident in the United States. This deduction is to be based on the provisions of Canadian law, as they may be modified without changing their general principle.

The proposed treaty preserves Canada's right to impose its "departure tax" on disposition of Canadian property by U.S. residents who formerly resided in Canada (Article XIII (Gains)). The proposed treaty provides that gains on such dispositions have their source in the United States (Article XXIV(3)(b)). The proposed first protocol makes it clear that Canada will credit the U.S. tax imposed on such gains against the Canadian tax imposed on such gains. Therefore, the U.S. tax on such gains will not be creditable against other Canadian taxes.

Other provisions

The proposed treaty in the various articles dealing with specific items of income provides source rules for determining when an item of income arises in one of the countries. These rules are used for credit or exemption purposes. In general, an item of income of a resident of one country that may be taxed in the other country under the treaty is considered to arise in that other country. Accordingly, income taxes paid to that other country on that income will be creditable (subject to any relevant limitations). Income that may not be taxed in the source country is deemed to arise in the residence country.

The proposed treaty also provides that any reference to income tax paid or accrued to a country includes Canadian tax and United States tax. Accordingly, those taxes, which are defined in Article II (Taxes Covered) are creditable under the treaty. In addition, the proposed treaty provides a credit for local taxes of general application provided the local authority does not impose the taxes in a manner inconsistent with the provisions of the treaty and the taxes are substantially similar to the taxes of the countries described in Article II. Thus, for example, Canada would allow a credit for a State income tax that was similar to the U.S. Federal income tax. Likewise, the United States will allow a credit for a provincial income tax that is imposed in a manner consistent with the provisions of the proposed treaty if it is substantially similar to the Canadian Federal income tax.

The proposed treaty also contains special rules for U.S. citizens who are residents of Canada. Under the first rule, Canada will permit the U.S. citizen a credit against Canadian tax imposed on certain income that arises in the United States. This credit is limited to the tax that the citizen would have paid if he were not a U.S. citizen. In addition, the United States will allow the citizen a credit against his U.S. tax for any tax paid to Canada after Canada has allowed the credit for U.S. taxes. The credit comes after the Canadian tax is reduced by the deduction for U.S. taxes.

A further special rule is provided for dividends, interest and royalties arising in the United States and beneficially owned by a citizen of the United States resident in Canada. Under this rule, Canada will permit a deduction of any U.S. tax paid on the dividends, interest and royalties but not reduced by Canadian taxes creditable for U.S. purposes in computing the U.S. net tax due. Canada will also allow a credit for U.S. tax imposed on that income, but Canada may limit the credit to 15 percent of the gross amount of those items included in income for Canadian tax purposes. The United States will allow a credit against U.S. tax imposed on that income for Canadian tax after the credit allowed for U.S. taxes paid or accrued on the income. The United States does not have to allow the credit to the extent it reduces U.S. tax below 15 percent of the gross amount of the interest, dividends, and royalties.

The proposed treaty provides for a limited resourcing of income to give effect to the special rules for U.S. citizens resident in Canada. In addition, the proposed first protocol clarifies the application of the U.S. foreign tax credit limitation where income is resourced to Canada under the treaty. The proposed first protocol provides that the proposed treaty's source rules will not apply for the purpose of calculating the U.S. credit for non-U.S. taxes other than Canadian taxes. That is, U.S. source income that is resourced to Canada under the treaty will remain U.S. source income for the purpose of calculating the overall limitation and thus the amount of non-Canadian taxes eligible for the U.S. foreign tax credit.

Finally, a credit is provided for capital taxes imposed by one country on capital of a resident of the other country.

Article XXV. Nondiscrimination

The proposed treaty contains a nondiscrimination provision relating to all income taxes of every kind imposed at the national level. It is similar to provisions which have been embodied in other recent U.S. income tax treaties. There are, however, some important differences.

Under the provision, neither country can discriminate by imposing more burdensome taxes (or other requirements connected with taxes) on citizens of the other country resident in the host country than it imposes on its own citizens who are in the same circumstances.

The proposed treaty provides that citizens of one country not resident in the other country cannot be subjected in that other country to more burdensome taxes (or requirements connected with taxes) than those to which a similarly situated citizen of a third country would be subject. The phase "the same circumstances" includes residence in the same country as those as against whom he believes he is being discriminated. Accordingly, Canada could discriminate against a U.S. citizen not resident in Canada vis-a-vis a Canadian resident. However, Canada could not discriminate against a U.S. citizen resident in country A vis-a-vis a French citizen resident in country A. One major purpose of this provision is to guarantee a U.S. citizen resident in a third country the benefits of any tax treaty between Canada and that country.

The proposed treaty provides that a resident of one country may take dependents' allowances or deductions to the extent provided for by the country of residence for dependents residing in the other country. This rule is the same as that provided under U.S. law but is a change from Canadian law which does not permit those allowances.

The proposed treaty also permits a married Canadian resident who is not a citizen of the United States to claim joint return rates for dependent personal service income. The provision does not apply if the individual's earnings are exempt from tax under Article XV. The provision is limited so that any benefit derived is available only to wage income.

The proposed treaty provides for limited nondiscriminatory treatment for corporations resident in one country owned by residents of the other country. Under the proposed treaty, a corporation which is resident in one country and which is owned by residents of the other country cannot be subject in the country of residence to other or more burdensome taxation (or related requirements) than the taxation and related requirements to which other similar corporations of the country of residence which are wholly or partially owned by residents of a third country may be subjected. For example, Canadian companies owned by U.S. residents cannot be taxed in a more burdensome manner than a Canadian company owned, for example, by a Swiss resident, whatever rights that Canadian company has under the Swiss-Canadian income tax treaty. However, a Canadian subsidiary of a U.S. company can be taxed in a more burdensome rate than a Canadian company owned by Canadians.

Under the proposed treaty, neither country may tax a permanent establishment of a resident of the other country less favorably than it taxes its own residents carrying on the same activities. Consistent with the U.S. and OECD models, however, a country is not obligated to grant residents of the other country any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents. In addition, the proposed first protocol makes it clear that neither country need grant to a company that is a resident of the other country the same tax relief that it provides to a company that is a resident of the taxing country with respect to dividends received. Thus, the United States would not have to allow the dividends received deduction to Canadian corporations. Even absent such a specific treaty provision, the United States contends that treaty nondiscrimination provisions do not require extension of the dividends received deduction to foreign corporations.

The proposed treaty also provides that expenses paid by a resident of one country to a resident of the other must be deductible as if paid to a resident of the country of the payor. Further, for purposes of capital taxes, debts owed residents of the other country are to be deductible to the extent that they would be deductible if owed to residents of the country of residence of the obligor.

The proposed treaty would, however, permit a country to continue discriminatory laws relating to the deductibility of interest provided the laws are in force as of September 26, 1980 (the date of the signing of the treaty), including any later modification of those laws that does not change their general nature. It would also permit a country to continue in effect any provision of its internal law designed to insure that a nonresident does not obtain a tax treatment more favorable than that obtained by its own residents.

The proposed treaty also contains a reciprocal provision that permits a citizen or resident of one country to deduct expenditures incurred in attending a convention held in the other country to the extent that they would be deductible under the laws of the country of citizenship or residence if the convention was held in that country. This provision was intended to override U.S. law which denied deductions for expenses incurred in attending foreign conventions with certain exceptions limited to the relevance of the situs of the convention. However, Public Law 96-608, enacted December 28, 1980, amended the Code to permit deductions for conventions in Canada to the extent permitted under normal U.S. rules. The provision does have the effect of requiring Canada to grant deductions for conventions in the United States.

Article XXVI. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision which authorizes the competent authorities of the United States and Canada to consult together to attempt to alleviate individual cases of double taxation or cases of taxation not in accordance with the proposed treaty.

Under the proposed article a resident or citizen of one country who considers that the action of the countries or either of them will cause for him taxation not in accordance with the treaty may present his case to the competent authority of the country of which he is a resident or citizen. The claim must be presented in writing. The competent authority then determines whether the claim has merit. If it determines that the claim does have merit, and if the competent authority cannot unilaterally solve the problem, that competent authority endeavors to come to an agreement with the competent authority of the other country to limit the taxation which is not in accordance with the provisions of the treaty.

A second provision directs the competent authorities to resolve any difficulties or doubts arising as to the application of the convention. Specifically, they are authorized to agree as to the attribution of profits to a resident of one country and its permanent establishment in another country, the allocation of income, deductions or credits and the readjustment of taxes, the determination as to source of income, the characterization of items of income, and to the common meaning of terms. Under this authority, the Internal Revenue Service from time to time issues rulings defining terms in a treaty. The proposed treaty contains a provision, not found in most existing treaties, that permits the competent authorities to agree to increase dollar amounts reflected in the treaty to reflect monetary or economic developments.

The competent authorities may also consult for the elimination of double taxation in cases not provided for in the proposed treaty.

The treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of the mutual agreement provision. It also authorizes them to meet together for an oral exchange of opinions. These provisions make clear that it is not necessary to go through normal diplomatic channels in order to discuss problems arising in the application of the treaty and also removes any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or Canada.

Finally, the provision provides for the waiver of the statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding the statute of limitations. The provision, however, does not authorize the imposition of additional taxes after the statute of limitations has run. Furthermore, it only applies if the competent authority of the country other than the country to which the case has been presented is notified within six years from the end of the taxable year to which the case relates.

Article XXVII. Exchange of Information

This article forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of their respective taxes and to enable them to obtain information so that they can properly administer the treaty. The proposed treaty provides for the exchange of information which is necessary to carry out the provisions of the proposed treaty or for the prevention of fraud or for the administration of statutory provisions concerning taxes to which the convention applies. The exchange of information rules also apply to any taxes imposed by Canada on estates and gifts, to taxes Canada imposes under the Income Tax Act, and to all taxes that the United States imposes under the Internal Revenue Code. This would include, for example, social security and excise taxes.

The exchange of information is specifically not limited by the personal scope article. Thus, information can be exchanged with respect to persons not covered by the proposed treaty such as persons not resident in either country.

The information exchanged may relate to tax compliance generally and not merely to avoidance or evasion of tax.

Information exchanged is to be treated as secret in the same manner as information obtained under the domestic laws of the receiving country, except that it may be disclosed to persons involved in the assessment or collection of, the administration and enforcement in respect of, or litigation concerning, the taxes to which the treaty applies. It is understood by the countries that the legislative bodies involved in the administration of taxes, including their agents such as, for example, the U.S. General Accounting Office, could have access to such information as they consider necessary to carry out their oversight responsibilities. The information may be used for these purposes only. A country is not required to carry out administrative measures at variance with its laws or which it cannot obtain in the normal course of administration, or to supply information that would disclose a trade secret or the disclosure of which would be contrary to public policy.

The proposed treaty provides that a requested country will try to obtain the information requested the same way as if its own taxation was involved, notwithstanding the fact that the requested country does not, at that time, need the information. What this means is that a requested country will use its subpoena or summons powers or any other powers that it has under its own laws to collect information requested by the other country, even though it itself does not need that information for its own purposes. It is intended that the requested country may use those powers even if the requesting country could not under its own laws. Thus, it is not intended that the provisions be strictly reciprocal. For example, once the U.S. Internal Revenue Service has referred a case to the Justice Department for possible criminal prosecution, the United States investigators can no longer use an administrative summons to obtain information. If, however, Canada could still use administrative process to obtain requested information, it would be expected to do so even though the United States cannot. The United States could not, however, tell Canada which of its procedures to use.

Where specifically requested, the requested competent authority will attempt to provide the information in the form requested. Specifically, the competent authority will attempt to provide depositions of witnesses and copies of unedited original documents (including books, papers, statements, records, accounts, or writings) to the extent that they can be obtained under the laws and practices of the requested state in the enforcement of its own tax laws.

Article XXVIII. Diplomatic Agents and Consular Officers

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the taxation privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements. Accordingly, the convention will not defeat the general exemption from tax which a host country grants to diplomatic officials of the other country.

Article XXIX. Miscellaneous Rules

The proposed treaty contains a number of special rules that amplify or modify other provisions of the treaty.

The proposed treaty contains the general rule that its provisions will not restrict the right of a country to grant an exclusion, exemption, deduction, credit or other allowance whether currently allowed or later enacted in determining its own tax.

The proposed treaty also contains the "saving clause" contained in all U.S. income tax treaties that provides, with specific exceptions, that the treaty is not to affect the taxation by the United States of its citizens and residents or the taxation by Canada of its residents. The provision also applies to Canadian corporations that elect to be included in a consolidated return filed by a U.S. affiliated group of corporations. Consequently, unless otherwise specifically provided in the proposed treaty, the United States will continue to tax its citizens who are residents of Canada. Residents for purposes of the treaty (and thus, for purposes of the savings clause), include corporations and other entities as well as individuals (Article IV (Residence)).

Under Section 877, a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income tax, will, in certain cases, be subject to tax for a period of 10 years following the loss of citizenship. The proposed treaty, as amended by the proposed first protocol, contains the standard provision found in the U.S. model and most recent treaties specifically retaining the right to tax a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. tax. The proposed first protocol makes it clear that this right to tax continues whether the former citizen had a principal purpose of avoiding income tax or some other tax. Even absent a specific provision the IRS takes the position that the U.S. retains the right to tax former citizens resident in the treaty partner.

Exceptions to the saving clause are provided for the benefits conferred by the articles dealing with related persons (Article IX), Gains (Article XIII), residence-based taxation of pensions, annuities, and social security benefits (Article XVIII), U.S. beneficiaries of Canadian retirement plans and Canadian residents who are U.S. citizens who receive U.S. social security benefits (Article XXIX), certain transitional rules contained in paragraphs 3 and 5 of Article XXX, Government Service (Article XIX), Exempt Organizations

(Article XXI), Elimination of Double Taxation (Article XXIV), Nondiscrimination (Article XXV), and the Mutual Agreement Provisions (Article XXVI). In addition, the saving clause does not apply to individuals who are subject to the student article (Article XX) and who are neither citizens of nor have immigrant status in the country in which they are students. The proposed first protocol makes a technical alteration in one of the proposed treaty's exceptions to the saving clause. Before amendment by the proposed first protocol, the saving clause of the proposed treaty did not apply to any of the provisions of Article XVIII (Pensions and Annuities). That is, a country's right to tax pensions and annuities on the basis of residence or citizenship was subject to the limits of Article XVIII. The proposed first protocol makes it clear that a country retains the right to tax pension payments, annuity payments, and alimony and other similar amounts (including child support payments) on the basis of residence or citizenship of the recipient. The second protocol makes it clear that a country retains the right to tax social security benefits that it pays to its citizens that are residents of the other country.

The proposed treaty also contains a provision intended to grant relief from social security taxes imposed on employers, employees, and self-employed persons under the Internal Revenue Code. Under current law, the United States imposes such Social Security taxes on account of some Canadian individuals exempt from U.S. income tax (whether exempt under the Internal Revenue Code or exempt under the 1942 treaty). Canada and the United States have negotiated a Social Security totalization agreement that will limit such U.S. Social Security taxation for future years once it comes into effect. Before amendment by the proposed first protocol, the proposed treaty provided that with respect to taxable years not barred by the statute of limitations ending on or before December 31 of the year in which the proposed treaty entered into force, income from personal services that is not subject to tax by the United States under the existing (1942) treaty would not be considered wages or earnings from self-employment for purposes of social security taxes imposed under the Code. This provision would have permitted persons who have paid social security taxes for years which are still open, including the year in which the instruments of ratification are exchanged, to obtain a refund of those taxes. The proposed first protocol changes the event that triggers the U.S. obligation to grant relief from the entry into force of the proposed income tax treaty to the entry into force of the proposed Social Security totalization agreement. The proposed Social Security totalization agreement was submitted to Congress on January 26, 1984, and can go into effect after a congressional review period during which at least one House has been in session on each of 60 days. Thus, with respect to taxable years not barred by the statute of limitations ending on or before December 31 of the year before the year in which the proposed Social Security totalization agreement enters into force, income from personal services that is not subject to tax by the United States under the existing (1942) treaty or the proposed income tax treaty will not be considered wages or earnings from self-employment for purposes of social security taxes imposed under the Code. This provision will permit persons who have paid social security taxes for years which are still open, including the year before the year in which the totalization agreement comes into force, to obtain a refund of those taxes.

To avoid mismatching of income and credits, the proposed treaty permits the United States to recognize the tax deferral accorded by Canadian registered retirement savings plans. A beneficiary of a Canadian registered retirement savings plan may elect to defer U.S. tax on any income accrued in the plan but not distributed by the plan until the time a distribution is made from the plan or a plan substituted therefor. The Internal Revenue Service is to establish rules under which such an election may be made. This provision is intended to solve a problem which exists under current rules. Certain Canadian retirement plans which are qualified plans for Canadian tax purposes do not meet U.S. requirements for qualification. As a result, the earnings of the plans are currently included in income of a U.S. citizen or resident for U.S. tax purposes. The proposed treaty would prevent the mismatching of the income so that a U.S. person would be able to get a foreign tax credit for taxes paid when Canada finally taxes the income and the United States would then tax it at the same time.

Before amendment by the proposed first protocol, this provision applied only to beneficiaries of Canadian registered retirement savings plans who were both U.S. citizens and residents of Canada. The proposed first protocol no longer limits the application of this rule to U.S. citizens who are Canadian residents. However, the proposed first protocol provides that this benefit does not apply to income reasonably attributable to contributions made to the plan by the beneficiary while he was not a resident of Canada.

The benefits of the proposed treaty do not extend to certain entities that taxpayers might otherwise be able to use to avoid taxation. The proposed first protocol modifies the proposed treaty's rules in this regard. Articles VI through XXIV of the proposed treaty (as modified by the proposed first protocol) do not apply in two cases. First, they do not apply to income of a trust that is to be treated for treaty purposes as income of a resident of one of the countries if a principal purpose for the establishment, acquisition or maintenance of the trust was to obtain a benefit under the proposed treaty or under the existing (1942) treaty for persons who are not residents of that country. Second, Articles VI through XXIV do not apply to non-resident-owned investment corporations as defined under section 133 of the Income Tax Act of Canada, or under any similar provision enacted by Canada after the date of signature of the first protocol (June 14, 1983). This provision is different from that contained in the proposed treaty before modification by the proposed first protocol. Before modification, benefits would have been disallowed if 25 percent or more of the capital of a company which was a resident in one country were owned directly or indirectly by individuals who were not residents of that country, and if by reason of special rules a tax imposed by the country of residence of the company on that company with respect to dividends, interest or royalties arising in the second country were substantially less than the tax generally imposed by the country on corporate business profits. Before modification, the only treaty benefits disallowed were those relating to dividends, interest, and royalties.

The proposed second protocol adds a provision that exempts from U.S. tax one-half of the total amount of Canadian social security benefits paid in a taxable year to a Canadian resident who is a U.S. citizen. The saving clause does not apply to this provision.

Article XXX. Entry into Force

The proposed treaty contains detailed transitional rules. The proposed treaty is subject to ratification in accordance with the applicable procedures of each country and the instruments of ratification will be exchanged as soon as possible at Ottawa. In general, the proposed treaty will enter into force when the instruments of ratification are exchanged.

As a general rule, the treaty will become effective for taxable years beginning on or after January 1 of the year following the year in which the proposed treaty comes into force. For example, if the proposed treaty enters into force in 1984, it will generally be effective for taxable years beginning on or after January 1, 1985. With respect to the withholding taxes at source on dividends, interest, royalties, pensions, and annuities, the treaty will be effective on the first day of the second month next following the date on which the convention enters into force. Other special rules are also provided. The proposed first protocol adds a special effective date rule for the U.S. foreign tax credit. The obligation of the United States to grant a foreign tax credit under the proposed treaty is to have effect for taxable years beginning on or after January 1, 1981. For earlier taxable years, the proposed treaty does not ensure the creditability of Canadian taxes. Before amendment by the proposed first protocol, the United States' obligation to grant a foreign tax credit for Canadian taxes under the proposed treaty would have arisen under the proposed treaty's general effective date provision. That is, that obligation would have arisen only after the proposed treaty came into force.

Generally, the proposed treaty provides that the provisions of the current treaty that are more favorable than the provisions of the proposed treaty will remain in effect for an additional year.

The proposed treaty also provides that the present estate tax treaty between the United States and Canada will continue in effect for estates of persons who died prior to the first day of January following the date on which the treaty enters into force. The proposed treaty further provides, however, that the estate tax treaty will be terminated with respect to estates of persons who die on or after that date. This reflects the fact that Canada has repealed its Federal estate tax law and now taxes transfers by reason of death under its income tax law.

Article XXXI. Termination

The proposed treaty will continue in force indefinitely, but either country may terminate it any time after five years from its entry into force by giving at least six months prior notice through diplomatic channels.

If one of the countries determines that a significant change introduced in the laws of the other country should be accommodated by a modification of the treaty, the countries will consult together with a view to resolving the matter. If the matter cannot be satisfactorily resolved, then the State that feels that the other State had modified its laws in a significant way may terminate the treaty by giving notice through diplomatic channels, even if the five-year period has not elapsed.

If terminated, the termination will be effective with respect to dividends, interest, royalties, pensions, annuities and other income from amounts paid or credited on or after the first day of January next following the expiration of the six months notice.

Exchange of Notes

At the signing of the proposed treaty, notes were exchanged dealing with three issues. First, the notes recognize a definitional problem that the term "societe" also means a "corporation" within the meaning of Canadian law.

Second, the notes provide rules which permit a resident of one country to deduct as a charitable contribution contributions to certain organizations created or organized in the other country. The effect of this note is discussed under Article XXI.

Third, the notes state the Canadian position that the unitary tax system used by many States of the United States to allocate income to the United States offices or businesses of foreign companies result in inequitable taxation and also imposes excessive administrative burdens on Canadian companies doing business in those States. It is Canada's view that that method of computing taxable income by those State governments is not determined on the basis of arm's-length relations but is based on a formula taking into account the income of the Canadian company and its worldwide operations and subsidiaries, including the assets, payroll and salaries of all those companies. In the Canadian view, the requirement that a Canadian multi-national company submit its books and records of all its subsidiaries to a State of the United States imposes a costly burden. The notes reflect Canada's correct understanding that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the States by treaty and that a provision which would have restricted the use of the unitary apportionment was rejected by the Senate in the case of the United States-United Kingdom Treaty. The notes reflect Canada's concern about this issue and state that if an acceptable provision on unitary apportionment can be devised the United States will reopen discussions with Canada on that subject.

First Protocol

After the proposed treaty was signed, two proposed protocols modifying the proposed treaty were signed. The first protocol deals with a variety of issues, all of which are discussed in detail in connection with the Articles modified. The first protocol makes changes to Articles III (General Definitions), V (Permanent Establishment), VI (Income from Real Property), VIII (Transportation), XII (Royalties), XIII (Gains), XVI (Artistes and Athletes), XVII (renamed as Withholding of Taxes in Respect of Personal Services), XVIII (Pensions and Annuities), XXI (Exempt Organizations), XXIV (Elimination of Double Taxation), XXV (Non-Discrimination), XXIX (Miscellaneous Rules), and XXX (Entry into Force).

Most of the changes that the first protocol makes are technical. Article I clarifies the definition of "international traffic" in Article III of the proposed treaty. Article II clarifies the definition of permanent establishment in Article V of the proposed treaty to treat the use of an "installation" in a country to explore for or exploit natural resources like the use of a rig. Article III clarifies the proposed treaty's definition of income from real property (in Article VI of the proposed treaty). Article IV makes it clear that income of a resident of one country from use of containers in international traffic is generally exempt from tax in the other country. Article V clarifies the scope of the proposed treaty's royalty provisions (Article XII of the proposed treaty).

Article VI of the proposed protocol revises the rules of Article XIII of the proposed treaty governing gains from the disposition of real property and real property interests. The proposed protocol removes limitations that the proposed treaty would have imposed on the taxing jurisdiction of the situs country. The proposed protocol brings the proposed treaty, as amended, into closer conformity with the U.S. tax laws governing foreign investors in U.S. real property. It also allows greater source basis taxation by Canada. However, the proposed protocol still does not allow full source basis taxation, because it allows allows nonresident investors a step-up in basis in some cases. The proposed protocol modifies the transition rule for the basis step-up. It also clarifies Canada's right to impose a "departure tax" on disposition of Canadian property by a former Canadian resident.

Article VII amends Article XVI of the proposed treaty to clarify tax treatment of athletic teams and "bonus" payments to athletes. Article VIII amends the proposed treaty's treatment of withholding of tax on income from employment (Article XVII of the proposed treaty). Article IX clarifies the extent to which the countries agree to waive jurisdiction to tax pension, annuity, alimony, and support payments (Article XVIII of the proposed treaty). Article X amends Article XXI of the proposed treaty to make it clear that an entity used exclusively as a conduit to earn income for an employee benefit plan or fund is subject to the same treaty rules as an employee benefit plan or fund.

Article XI amends Article XXIV of the proposed treaty and eliminates the per-country limitation on the U.S. credit for Canadian taxes that the treaty had contained, provides that Canada will credit U.S. taxes imposed on former Canadian residents whom Canada subjects to its "departure tax," and restricts the proposed treaty's source rules so that they will not allow a U.S. tax credit for taxes other than Canadian taxes.

Article XII amends Article XXV of the proposed treaty to make it clear that neither country need grant to a company that is a resident of the other country the same tax relief that it provides to a company that is a resident of the taxing country with respect to dividends received.

Article XIII makes several changes to Article XXIX (Miscellaneous Rules) of the proposed treaty. Most importantly, it narrows the proposed treaty's anti-treaty shopping rules. In addition, it makes it clear that the U.S. right to tax a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of

U.S. tax continues whether the former citizen had a principal purpose of avoiding income tax or some other tax. The proposed protocol makes a technical alteration in one of the proposed treaty's exceptions to the saving clause. It changes the effective date of the obligation of the United States to grant relief from social security taxes imposed on employers, employees, and self-employed persons under the Internal Revenue Code. It clarifies the rules applicable to beneficiaries of Canadian registered retirement savings plans.

Article XIV amends Article XXX of the proposed treaty, and generally extends the obligation of the United States to allow its foreign tax credit for Canadian taxes to taxes paid in taxable years beginning on or after January 1, 1981.

Exchange of Notes under the First Protocol

At the signing of the proposed first protocol, notes were exchanged dealing with an additional issue. The existing (1942) treaty between the United States and Canada limits source country taxation of royalties, including natural resource royalties, to 15 percent of the gross amount. The proposed treaty contains no limitation on source country taxation of natural resource royalties. The notes indicate that the United States and Canada have agreed that if the United States increases its taxation of natural resource royalties above the current 30 percent of gross, or if Canada increases its taxation of natural resource royalties above the current 25 percent of gross, then, upon request by either country, negotiations will be resumed promptly with a view to considering an amendment to the treaty to provide an appropriate limit to the rate at which the source country may tax such royalties.

Second Protocol

The proposed second protocol deals with taxation of social security benefits, and is discussed in detail in connection with Articles XVIII (Pensions and Annuities) and XXIX (Miscellaneous Rules). It prevents U.S. taxation of social security benefits paid to Canadian residents who are not U.S. citizens (and vice versa), and it limits U.S. taxation of social security benefits paid to Canadian residents who are U.S. citizens.

Competent Authority Agreement Concerning Drilling Rigs

The United States and Canada have entered into a competent authority agreement limiting the taxation in Canada of income from U.S. drilling rigs engaged in offshore drilling operations and limiting Canadian taxation of dispositions and deemed dispositions of such rigs. A discussion of that agreement appears in connection with Article V (Permanent Establishment).

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