

May 2020

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Recommended Citation

Bernie M. Tuggle, The Proposed United States-Canada Income Tax Treaty, 10 Denv. J. Int'l L. & Pol'y 169 (1980).

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The Proposed United States-Canada Income Tax Treaty

A new income tax treaty between the United States and Canada was signed on September 26, 1980,¹ culminating a seven-year effort to revise the current treaty which dates back to 1942. While there are notable advantages to both American and Canadian taxpayers with the new treaty, Senate ratification of the treaty in its present form is far from certain. Natural resources companies and real estate developers with holdings in Canada are potential losers under the 1980 treaty and can be expected to lobby intensively for modification when the treaty comes up for approval in 1981.

All sides agree that a new treaty was needed because the old one is outdated.² Current investment attitudes of individuals and businesses differ dramatically from the pre-World War II investment attitudes expressed in the current treaty. Yet, while the new treaty may be welcomed as more reflective of the investment climate of the 1980's, one expressed concern with the new treaty is that it is a "labyrinth of detail, far more so than most tax treaties."³ Nevertheless, the 1980 treaty contains numerous potential benefits and losses to be enjoyed and suffered by investors.

In many respects, the new treaty does not significantly change the existing treaty. The 1980 treaty continues the joint American-Canadian effort to avoid double taxation and to prevent fiscal evasion with respect to taxes on income and capital.⁴ In addition, the treatment of income

1. Income Tax Treaty, Sept. 26, 1980, United States-Canada, *reprinted in* [1980] 12 FED. TAX TREATIES (P-H) 22,030 [hereinafter cited as 1980 Treaty]. See also Treas. Dept. Release M-678, Sept. 26, 1980.

2. *Hurdles Ahead for the U.S.-Canada Tax Treaty*, BUS. WEEK, Oct. 27, 1980, at 125. Current law consists of the original 1942 treaty and three supplemental treaties. Convention and Protocol for the Avoidance of Double Taxation and Prevention of Fiscal Evasion in the Case of Income Taxes, March 4, 1942, United States-Canada, 56 Stat. 1399, T.S. No. 983 [hereinafter cited as 1942 Treaty]; Convention Modifying and Supplementing the Convention and Accompanying Protocol of March 4, 1942 for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion in the Case of Income Taxes, June 12, 1950, United States-Canada, 2 U.S.T. 2235, T.I.A.S. No. 2347 [hereinafter cited as 1950 Treaty]; Convention Further Modifying and Supplementing the Convention and Accompanying Protocol of March 4, 1942 for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion in the Case of Income Taxes, as modified by the supplementary convention of June 12, 1950, Aug. 8, 1956, United States-Canada, 8 U.S.T. 1619, T.I.A.S. No. 3916; Convention Further Modifying and Supplementing the Convention and Accompanying Protocol of March 4, 1942 for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion in the Case of Income Taxes, as modified by the supplementary conventions of June 12, 1950 and August 8, 1956, United States-Canada, 18 U.S.T. 3186, T.I.A.S. No. 6415.

3. *Hurdles Ahead for the U.S.-Canada Tax Treaty*, note 2 *supra*.

4. Compare 1980 Treaty, *supra* note 1, Preamble with 1942 Treaty, *supra* note 2, Preamble.

from government sources,⁵ income for educational maintenance,⁶ exempt organizations,⁷ capital,⁸ and the income of artists and athletes⁹ remains virtually unchanged. The treaty also preserves the important goal of cooperation between the United States and Canada, particularly with the exchange of tax-related information.¹⁰ However, despite these similarities, important articles of the current treaty have been altered—these changes warrant close scrutiny by existing and potential investors on both sides of the border. The areas that have been changed include income derived from pensions and life annuities, pension fund income, capital gains, royalties, interest, branch office profits, and dividends.

Income derived from pensions and life annuities

Under the existing treaty, income from pensions (including government pensions) and life annuities derived from within one of the contracting states by a resident of the other contracting state is exempt from taxation in the former state.¹¹ The 1980 treaty, on the other hand, provides that pensions and annuities arising in one contracting state may be taxed in the other state.¹² The new treaty does, however, place a fifteen percent limit on the tax of the gross amount of pension income.¹³ This provision of the 1980 treaty will probably encourage Americans and Canadians to seek pension and annuity sources which are on their own respective side of the border. If the 1980 treaty is ratified in its present form, potential investors looking for a pension or annuity investment opportunity will be forced to consider not only financial but also geographical factors.

Pension fund income

The 1980 treaty exempts interest and dividends paid in one contracting state to a pension fund resident in the other contracting state if the fund's income is generally exempt from tax in the other contracting state.¹⁴ Canadian dividends, for example, which are paid to an American pension fund would be exempt from any Canadian tax if the American fund is a United States Treasury-qualified pension fund. This is a notable change from the existing treaty which contains no such provision for pen-

5. Compare 1980 Treaty, *supra* note 1, art. XIX with 1950 Treaty, *supra* note 2, art. VI.

6. Compare 1980 Treaty, *supra* note 1, art. XX with 1942 Treaty, *supra* note 2, art. IX.

7. Compare 1980 Treaty, *supra* note 1, art. XXI with 1942 Treaty, *supra* note 2, art. X.

8. Compare 1980 Treaty, *supra* note 1, art. XXIII with 1942 Treaty, *supra* note 2, art. V.

9. Compare 1980 Treaty, *supra* note 1, art. XVI with 1950 Treaty, *supra* note 2, art. VII.

10. Compare 1980 Treaty, *supra* note 1, art. XXVII with 1942 Treaty, *supra* note 2, arts. XX, XXI.

11. Compare 1980 Treaty, *supra* note 1, art. VI with 1950 Treaty, *supra* note 2, art. VI(A).

12. 1980 Treaty, *supra* note 1, art. XVIII.

13. *Id.* art. XVIII, para. 2.

14. *Id.* art. XI, para. 3.

sion dividend and interest income exemption. This particular exemption should increase the movement of investment dollars across the border,¹⁵ and it is unlikely that this aspect of the 1980 treaty will meet any Senate resistance.

Capital gains

The 1942 treaty provides that "gains derived in one of the contracting states from the sale or exchange of capital assets by a resident . . . of the other contracting state are exempt from taxation in the former state, provided such resident . . . has no permanent establishment in the former state."¹⁶ Therefore, most capital gains realized in Canada by American investors are exempt from Canadian taxation. The 1980 treaty, meanwhile, divides capital gains into real estate gains and gains derived from the sale of securities. Real estate capital gains will be hit hard by the new treaty which states that "gains derived by a resident of a contracting state from the alienation of real property situated in the other contracting state may be taxed in that other state."¹⁷ There is no limit on the amount of such taxation, and real estate capital gains will be subject to the maximum Canadian and American capital gains tax.

Real estate capital gains will probably be one of the more contested issues when the treaty comes before the Senate. Real estate developers with American and Canadian holdings would be subject to taxation on both sides of the border for real estate capital gains under the new treaty and will undoubtedly lobby for modification. This aspect of the 1980 treaty, if passed would certainly slow the amount of American dollars invested in Canadian real estate.

Capital gains from the sale of securities is generally exempt from double taxation under both the current and new treaties.¹⁸ The new treaty, however, does change the treatment of such capital gains in one important area: capital gains derived from the sale of shares of real estate companies are subject to double taxation.¹⁹

Royalties

Royalties are exempt under the 1942 treaty if the party was not engaged in trade or business in the foreign state through a permanent establishment.²⁰ However, if an American did carry on a trade or business in Canada at a permanent establishment, then royalties from either personal or real property could be taxed at a maximum of fifteen percent.²¹ Income from royalties receives a different treatment under the 1980 treaty. Royalties derived from personal property "arising in a contracting

15. *Hurdles Ahead for the U.S.-Canada Tax Treaty*, note 3 *supra*.

16. 1942 Treaty, *supra* note 2, art. VIII.

17. 1980 Treaty, *supra* note 1, art. XIII, para. 1.

18. Compare 1942 Treaty, *supra* note 2, art. VIII with 1980 Treaty, *supra* note 1, art. XIII.

19. 1980 Treaty, *supra* note 1, art. XIII, para. 3(a).

20. 1942 Treaty, *supra* note 2, art. XIII(C).

21. *Id.* art. XI.

state and paid to a resident of the other contracting state may be taxed in that other state,"²² but this tax cannot exceed ten percent of the gross amount of the royalties.²³ Personal property royalties taxation, then, would decrease five percent if the new treaty is ratified.²⁴ This should encourage American companies to view Canada as a more attractive ground for licensing.

Royalties from real property, meanwhile, are taxable at the maximum Canadian rates under the new treaty.²⁵ Natural resources companies which derive income from oil and mineral royalties will be subject to the Canadian tax in addition to the American tax. American oil companies with land holdings in Canada will likely lead an intensive lobbying effort to change this portion of the treaty.

Interest

Under both the existing and new treaties, interest accruing in a contracting state and paid to a resident of the other contracting state may be taxed in the accruing state at a rate not to exceed fifteen percent.²⁶ However, the 1980 treaty exempts interest paid on government, provincial, and local bonds.²⁷ Since a United States investor who buys Canadian government bonds will now receive interest payments not subject to Canadian or American taxation, and at the same time, interest paid to Canadians on United States Treasury, state, and local bonds is to be exempt from United States, as well as Canadian, taxation, this change could help broaden the American and Canadian markets for such issues.

Branch office profits

Branch office profits receive a more favorable treatment under the new treaty, with the maximum tax lowered from fifteen to ten percent with the first \$500,000 exempt.²⁸ The 1980 treaty provides that this exemption applies if one company "directly or indirectly controls the other, or both companies are directly or indirectly controlled by the same person or persons, or if the two companies deal with each other not at arm's length."²⁹ This decrease of five percent realized under the 1980 treaty may lead to the expansion of companies across the United States-Canada border.

Dividends

At present, dividends paid by a Canadian corporation to an Ameri-

22. 1980 Treaty, *supra* note 1, art. XII, para. 1.

23. *Id.* para. 2.

24. For example, an American company that licenses patents in Canada will be taxed in Canada at 10%, instead of the present 15% of income received from the patent.

25. 1980 Treaty, *supra* note 1, art. XII, para. 4.

26. 1950 Treaty, *supra* note 2, arts. XI, XII.

27. 1980 Treaty, *supra* note 1, art. XI, para. 3.

28. Compare 1942 Treaty, *supra* note 2, art. XII, with 1980 Treaty, *supra* note 1, art. X, para. 6.

29. 1980 Treaty, *supra* note 1, art. X, para. 6(d).

can be subject to Canadian taxation of fifteen percent.³⁰ However, dividends paid by an American corporation whose business is "not managed and controlled"³¹ in Canada to a non-Canadian recipient is exempt from all taxes imposed by Canada.³² The new treaty provisions state that dividends paid by a Canadian company to an American investor may be taxed in the United States and in Canada, but if an American is the beneficial owner of such dividends, the rate charged shall not exceed:

- (a) 10 percent of the gross amount of the dividends if the beneficial owner is a company which owns at least 10 percent of the voting stock of the company paying the dividends;
- (b) 15 percent of the gross amount of the dividends in all other cases.³³

Several general comments about the new Canada-United States income tax treaty should be made. The new treaty changes the treatment of income derived in various ways from real property. Real estate capital gains, royalties from real property, and capital gains derived from the sale of real estate company stock are all subject to some form of double taxation. This will obviously encourage Canadian and American investors looking across the border to seek non-real estate investment opportunities.

The treaty is indeed a "labyrinth of detail." Extreme caution should be exercised when the treaty is read because different articles interact in subtle ways, for example, dividends and capital gains treatments make investment decisions difficult to make. It is suggested that this treaty be read only after the earlier ones are studied and understood.

Finally, until the treaty is ratified and its final form ascertained, great care should be used by potential investors. For example, a decision to speculate in Canadian securities because of the adverse treatment that real property capital gains receive might later prove to be the incorrect financial decision if the Senate modifies the real estate capital gains section of the treaty. Indeed, the hurdles ahead for this treaty should place the potential investor on guard and possibly cause him to postpone any decisions until ratification.

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30. 1942 Treaty, *supra* note 2, art. XII.

31. In a letter from the Canadian Under-Secretary of State for External Affairs to the American Ambassador, the Under-Secretary wrote that "so long as the stock control of the corporation is not in Canada, its directors' meetings and shareholders' meetings are not held in Canada and its 'management-control' is not in Canada, the corporation is not managed and controlled in Canada." Letter of Feb. 20, 1951, *reprinted in* 2 U.S.T. 2246.

32. 1950 Treaty, *supra* note 2, art. XII.

33. 1980 Treaty, *supra* note 1, art. X, para. 2.

