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Robert D. Brown

Negotiations for a New Tax Treaty Between Canada and the United States—A Long Story with a Happy Ending?

*by Robert D. Brown**

My topic this afternoon is the alleged new Canada-United States Tax Treaty—a treaty which has not yet been signed, and which we are not sure will ever be signed—but that makes it all the more intriguing as a topic of discussion.

Contrary to rumour, it is not true that negotiations between Canada and the United States over a new tax treaty have been going on ever since the War of 1812. In fact, the latest round of discussions have been meandering along for only eight years, which is a mere blink of a gnat's eye in terms of the speed at which our governments usually move.

Despite the length—and difficulty—of these negotiations, both governments and taxpayers agreed that the present antiquated and creaking 1942 Convention urgently needs repair. Unfortunately, the complexity of the issues and some major policy differences have meant that the task of drafting a mutually acceptable treaty has not been either easy or brief.

The optimism of the negotiators themselves about reaching agreement on a new treaty has certainly varied from time to time. On some occasions, such as in 1975 and the fall of 1978, the negotiating teams from both Canada and the United States were strongly implying that a major breakthrough was just around the corner and a new treaty would be signed shortly. However, we in fact turned the corner into 1979 and then into 1980 without a new treaty. The current negotiations have of course never been broken off: representatives of the two governments have met regularly (including in such exotic places as Paris and Puerto Rico) and have had even more frequent telephone discussions. (This may, in fact, be the first case of a tax treaty largely negotiated by telephone.) The most recent talks were held only a month or so ago. But it is the spring of 1980, and the return of the warm weather which seems to have brought a new feeling of confidence, or rather of extremely guarded optimism that 1980 may just be the year when a new treaty finally emerges.[1]

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* F.C.A., Price Waterhouse & Co., Toronto, Ontario.

[1] In a press release dated May 23, 1980, Canada's Finance Minister, Allan J. MacEachen announced that negotiations on a new Canadian-U.S. Tax Treaty had been virtually completed, and that a final version of the new Treaty was being prepared for the signature of the parties. This address was prepared before this announcement.

VITAL NATURE OF THE TREATY

The tax treaty between Canada and the United States may well be the most important tax treaty in the world, in the sense that it covers a larger volume of trans-border investment and business activity than any other international tax convention.

It is therefore rather remarkable that the present Canada-U.S. Tax Convention, which was signed in Washington on March 4, 1942, has lasted almost 40 years. While the treaty has, on the whole stood the test of time remarkably well, its 22 articles are now generally agreed to be antiquated, with technical flaws, ambiguities, and uncertainties. Accordingly, a comprehensive new tax treaty between the two countries, dealing with a wider range of issues and providing clearer rules to resolve conflicts would be generally welcomed by taxpayers and revenue authorities alike.

NOW OR NEVER

It is, of course, very difficult for anyone outside of the negotiation process to comment as to whether a new tax treaty will be finally agreed to in 1980; this seems, however, to rest more on some basic political haggling than on any major technical issues outstanding between the countries. But I think that it is possible to say that if a new tax treaty between Canada and the United States is not finally agreed upon in 1980, it may be years before we can reach such an agreement.

For one thing there is a distinct possibility of significant personnel changes in the negotiation teams on both sides of the border later this year, and bringing new negotiators into the process would complicate the process. For another, it seems that the negotiations to date have led to substantial agreement on the new treaty; it appears that there are only a few vital issues left which have not been settled, and if a mutually satisfactory compromise cannot be reached on these points during the next year, it is doubtful whether it can be reached at all in these economically troubled times.

The lengthy and tortuous negotiations between the two countries over a new tax treaty have been conducted in private, and neither side has made public its precise negotiating position. This lack of information will not, however, prevent me from making some personal speculations as to how the negotiations have been progressing, and even as to some of the terms of a new treaty if one is concluded. A good deal of the available information comes from a U.S. Treasury hearing on December 13, 1978 chaired by David Rosenbloom, International Tax Counsel for the U.S. Treasury, and one of the principal U.S. tax treaty negotiators. At this hearing, the U.S. Treasury representatives outlined in rather candid detail their general approach to the Canada-U.S. negotiations. While the Canadian government has never seen fit to be equally frank with its citizens regarding its side of the negotiations, it has been possible to pick up tid-bits of information through private conversation with some of the negotiators on each side of the border, talks with some of the industry representatives who are trying to provide input into the negotiation process, and some personal guess work as to where the negotiations will likely wind up given the track record and stated policies of both governments.[2]

Dimensions of the New Treaty

One thing that does emerge quite clearly from these open and bootleg sources of information is that the negotiations between the two governments are among the most time consuming and sophisticated in which either has ever engaged. While the negotiations have not yet resulted in a final agreement between the governments, they have at least developed a confidential working draft of the treaty on which both parties have reached some sort of general agreement.

It also appears that this working draft is extremely comprehensive and lengthy and deals with many issues in considerably more technical detail than is the case with the OECD Model Treaty or the U.S. Treasury draft treaty. The close relationship and the size and complexity of the economic issues between the countries have raised issues which are not present, at least to some degree, in other treaties negotiated by either country and have led to a desire to be more precise (or perhaps just more verbose) on a wide variety of issues.

Therefore, if the new treaty ever does see the light of day, it will be something of a first in international tax treaties and may well set a world record for length and complexity. (Given the philosophy and drafting style of the bureaucrats working on both sides of our border, this is perhaps not an unexpected result.)

There are, of course, a number of major problems that had to be overcome in the negotiations, including the fact, for example, that Canada taxes on the basis of residence together with taxing the gains of residents who foolishly depart Canada either by emigrating or dying, while the United States insists on taxing both on the basis of residence and citizenship (or place of incorporation). The United States, perhaps a trifle wistfully, still considers itself a capital exporting country and wishes to provide for a relatively free flow of interest, dividends, and capital between countries. Canada, with the highest rate of foreign investment of any developed country in the world, is not all that anxious to throw open its borders to U.S. investment without at least getting some shot at taxing those dollars. The United States clearly favours the system of taxation which gives the country in which the taxpayer lives the primary right to

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[2] *See also* the Canadian government press release of May 23, 1980 which was issued after this address was prepared.

tax him; whereas Canada, as a capital importing country, wants to assert that it is the country where the source of the income is, rather than where the taxpayer resides, that should have the first kick at the taxation cat. These broad and important differences have naturally made the negotiations of a new treaty more difficult, and the compromises more complex.

Business Income

With respect to the taxation of business profits, the U.S. and Canadian positions are understood to be quite similar to the OECD Model. Therefore, the general rule will continue that business profits would only be taxable in a jurisdiction if attributable to a permanent establishment in that country. Canada, however, is evidently seeking new rules which would clearly overcome the remaining "force of attraction" provisions under the Internal Revenue Code.

Rumour has it that the United States had taken a preliminary position that film rentals and royalties, as well as the rental of tangible or moveable property, should be regarded as business profits. Such income earned by a U.S. enterprise would therefore be exempt from Canadian withholding tax, and indeed from any Canadian tax whatsoever if no permanent establishment was maintained in Canada. Canada is, of course, resolutely opposed to this view, and as in its other treaties, will likely prevail in its contention that film royalties and property rentals should be subject to a moderate rate of withholding tax where derived from Canadian sources.

The articles dealing with the taxation of business income will probably clear up a few basic uncertainties; the term "enterprise," as used in the present treaty, has no particular judicial meaning in either country and will likely be dropped in favour of a reference to residents of each treaty country, with specific rules to determine the residence of both individuals and corporations which might otherwise claim dual residency. It seems possible that corporations incorporated in one country will remain, for the purposes of the treaty, resident in that country forever after, and that specific rules will remove any possibility of Canadian corporations escaping the Canadian tax net by continuing themselves under the laws of another jurisdiction, such as for example, continuing an Alberta corporation under Wyoming law.

Dividends

The appropriate taxation of dividends flowing between two countries would appear to be perhaps the main stumbling block in the negotiation of a new tax treaty. The present Canada-U.S. treaty provides for a general 15 percent withholding tax on dividends paid from either country to portfolio or direct investors in the other.

The basic policy position of the U.S. Treasury here and elsewhere is that its tax treaty should provide for withholding rates not in excess of 15 percent for portfolio investors, and 5 percent for direct corporate investors owning perhaps 10 percent or more of the stock of the foreign corporation.

Canada, however, has an extraordinarily high level of foreign investment and the taxation of dividends paid to non-residents is an issue which has very serious economic and political ramifications, particularly as the new Canadian administration is adopting a more nationalistic attitude generally on economic issues. As a policy matter, both the previous Conservative and the present Liberal administrations would clearly prefer to maintain the higher level of withholding taxes of 15 percent, and Canada has certainly stuck to this level in all of its previous tax treaties. The Canadian position in this area is reinforced by the fact that dividend flows out of Canada are substantially higher than dividend flows into Canada. Cutting the withholding tax rates therefore involves a significant revenue loss. (At least some of the larger Canadian corporations with subsidiaries in the United States are no longer so upset by the 15 percent tax on dividends from the United States, since they have now transferred their subsidiaries to Netherlands holding companies.)

The U.S. Treasury, in considering the dividend withholding issue, has undoubtedly made reference to the fact that Canada has a partially "integrated" tax system providing for substantial dividend tax credits to Canadian individuals in respect of dividends from Canadian corporations. The basic U.S. Treasury position is that any country having such an integration tax credit on dividends should extend them, at least partially, to foreign shareholders under tax treaties. The United States regards a system in which dividend tax credits are restricted to domestic shareholders as either discriminatory against U.S. investors at the corporate level, if the credits are viewed as a reduction of corporate tax, or as resulting in an inappropriately high withholding tax, if the credits are viewed as an adjustment of tax at the shareholder level. It is also noteworthy that the United States has managed to extract some flow through to U.S. investors of integration credits in its recent tax treaties with France, and most notably with the United Kingdom. Flushed with this success, the U.S. negotiators are likely very critical of Canada's attitude that the dividend tax credit, now 50 percent, is reserved exclusively for Canadians. The Canadian side undoubtedly has argued that the Canadian dividend tax credit differs substantially from the integration systems in use in France, Germany and the United Kingdom, because under the Canadian system, the tax credit to the shareholder is not related to the actual amount of corporate tax paid by the corporation, and is not refunded to the shareholder if it exceeds his actual tax.

Based on the usual unreliable sources, it is plausible to speculate that a possible solution to the whole integration and withholding rate question might be a lower rate of withholding tax on dividends paid by Canadian corporations to at least direct investors in the United States. The question that Canada has to answer is whether some modest downward adjustment in the rate of withholding tax on dividends to at least direct foreign investors is an acceptable price to pay for the ability to conclude a new and much more satisfactory treaty.[3]

Branch Tax

The U.S. authorities are also known to be concerned about the so-called Canadian "branch tax." This tax, designed to be the equivalent of a dividend withholding tax, is imposed on the net cash profits of the Canadian branch of a foreign corporation at a general rate of 25 percent. This is reduced unilaterally to 15 percent in the case of branches of a U.S. corporation.[4]

The United States has no corresponding tax, and U.S. policy, in cases where a foreign country does impose a branch tax, will generally be to retain a provision in the U.S. law imposing a dividend withholding tax on dividends paid by a foreign corporation if 50 percent or more of its revenue was from U.S. sources.

Interest

The present general rate of withholding tax on interest between the two countries is set by the treaty at 15 percent. The United States, as a net creditor of Canada, would clearly prefer to have a lower rate of withholding tax and just as clearly Canada would prefer not to agree to this, particularly in non-arm's length situations where there could be a rather obvious revenue drain.

The situation has been somewhat diffused by the fact that Canada has unilaterally exempted most long term arm's length borrowings from any withholding tax, along with interest on government bonds and certain other securities. The United States is understood to be prepared to accept a reasonable reciprocal rate of withholding tax on interest under the treaty, likely 15 percent, but would also like to incorporate some specific references to exemptions for particular types of interest. Interest on short-term trade accounts may also be exempted from withholding.

Royalties

The general U.S. approach has been to argue that royalties should be exempt from tax at the source, and should only be taxable in the country of the recipient. The current tax treaty with Canada has a 15 percent

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[3] The Canada Press Release of May 23 indicates that the two countries have agreed to a reduced withholding tax rate of 10 percent on direct investment dividends, patent royalties and technical know-how payments, and 15 percent on portfolio dividends, interest and certain pensions. Dividends would be regarded as flowing from a direct investment if at least 10 percent of the voting shares are owned.

[4] While not dealt with in the Press Release, it is understood that the new treaty may reduce the tax to 10 percent.

limitation on royalty payments, and Canada has maintained either a 15 percent or 10 percent withholding tax on royalties in its tax treaties. It seems on the whole unlikely that Canada would agree to any rate of withholding tax on royalties lower than 10 percent,[5] but in addition to the rate there are a number of other issues, such as a possible sourcing rule for royalties, that are understood to be under discussion.

Capital Gains

The present capital gains article in the treaty (Article VIII) is a very general five-line provision, entered into while Canada was still almost 30 years away from taxing capital gains. While the provision has stood up remarkably well over time, there are now a whole host of issues that remain unresolved or only partly resolved relating to the application of this provision.

The issues that are likely being dealt with under the capital gain article are understood to be numerous, and at the U.S. Treasury hearing in 1978, it was noted that the five-line article in the present treaty had turned into a series of articles of rather extraordinary length and complexity in the working draft; this is of course a reflection of the history of the tax legislation in our two countries over the past 40 years.

The U.S. administration clearly has an interest in taxing foreigners on sales of U.S. real estate (or "immoveable property") and accordingly is likely to agree with the Canadian position that each country should have the right to tax real estate gains occurring within its borders.[6] Moreover, this right will likely be further extended to include the right to tax nonresidents on the sale of shares of any corporation with a substantial holding in U.S. real estate.

In other cases, it is probable that the right of one country to tax the capital gains of residents of the other will be limited to business property associated with a permanent establishment and that gains on the sale of corporations, other than those holding land, will remain only taxable in the country of the vendor.

One of the thorniest issues to be wrestled with is the fact that Canada imposes taxation on certain "deemed" gains, including a deemed realization by taxpayers when they leave Canada, either by death or by emigration. The United States clearly wishes to avoid some arguments that have arisen in the past as to the coverage of the present article, so

[5] This is the rate indicated in the Press Release.

[6] The Press Release indicates that: "Any profit or income from real property, including natural resource royalties, may be fully taxed in the country where the property is located. In addition, any gain arising on the disposition of certain property, including real property and business assets of a permanent establishment in a country, may also be fully taxed in that country. As the proposed treatment of capital gains will represent a significant change from the existing convention a special transitional rule will be provided to avoid the disruptive effect of the change on existing investments."

that it can be expected to cover both actual and deemed gains of all sorts.

There are a wide variety of other issues that are caused by the Canadian deemed realization on leaving Canada, and the treaty most likely will deal with these in some depth, on a basis that will leave intact Canada's right to impose such a departure tax and, to rub salt in the wounds, also to restrict a number of present strategies that are used under the treaty to reduce such taxes.

In the case of U.S. citizens who are leaving Canada, there is a possibility that the new treaty might provide that the United States would permit the taxpayer to have his accrued capital gains taxed in the United States at the same time that they are taxed in Canada, thus ensuring a proper match of foreign tax credit. The United States might also be prepared to allow a departing Canadian citizen taking up residence in the United States to adopt as a cost base the fair market value recognized as a realization under Canadian law.

One of the issues that is certain to be covered is the interaction of the capital gain provision of the treaty and certain gains on resource properties, timber holdings, and certain other types of assets which Canada taxes as ordinary income but which in the U.S. view are clearly capital assets. Again, Canada is likely to preserve and even expand its right to tax such gains.

There was some indication, at the Washington hearing, that because the present treaty capital gains article will be broader than the new provisions, there may be "liberal" transitional rules.

Pensions and Annuities

With respect to pensions and annuities, Canada has always maintained the right of the source country to tax such payments, while the United States has generally argued that this type of income should be taxable only in the country of residence. It appears that the United States will be prepared to accept some limited Canadian taxation of pensions and annuities from Canada, provided that the Canadian withholding tax is not likely to exceed the available foreign tax credit in the United States. It also seems that the new rules may prevent Canadian taxpayers who emigrate to the United States from extracting income from Canadian Registered Retirement Savings Plans, and income averaging annuities, at quite the modest tax cost that is now available.

The new treaty rules will not cover social security contributions, which will have to be dealt with in a separate totalization agreement.

Foreign Tax Credits

The new treaty is said to be much more specific about the foreign tax credits to be granted by each government in respect of the taxes of the other. Specifically, it is understood that the U.S. Treasury has been reluctantly forced into agreeing that Canadian income tax is in fact an income tax that the United States will grant credit for. Due to the fact that not all expenses recognized for U.S. purposes are claimable in Canada, there had been some arguments raised by the Treasury that perhaps Canada did not have an income tax at all—a finding that would have been greeted with some surprise by the 10 million beleaguered Canadians who have to pay it.

U.S. CITIZENS

A large number of the more technical tax problems that will have to be dealt with in the treaty relate to the fact that the United States imposes taxes on the basis of citizenship. In the case of U.S. citizens who are living in Canada, the previous problems that they have faced have been made far worse by new Canadian tax rules. One of these limits the foreign tax credit claimable by a Canadian resident in respect to foreign portfolio investment income (other than from real estate) to a maximum of 15 percent of the gross income. A U.S. citizen resident in Canada and receiving investment income from the United States or from third countries, frequently finds himself subject to U.S. tax on such income well in excess of 15 percent, and thus a large part of this U.S. tax may not be creditable on the individual's Canadian tax returns. A new proposal in Finance Minister MacEachen's non-budget of April 21 would effectively prevent U.S. citizens in Canada from claiming any credit or deduction in respect to U.S. taxes imposed on Canadian source income.

It seems probable that these difficulties will be dealt with along the lines of the recently negotiated protocol to the tax treaty between the United States and France. Here, the United States has the right to impose a withholding tax on investment income paid to residents of France, including U.S. citizens; France then imposes its normal tax, giving a credit for the U.S. withholding tax, and the United States, in the case of U.S. citizens, can then impose some further layer of tax on its hard-done-by citizens living in France, but with full credit for both the United States and French tax already imposed.

COMPETENT AUTHORITY

The new treaty is alleged to have more effective competent authority provisions, including some extension of statutory limitation periods and other rules to make cross-border adjustments more effective. Equally, it is also understood to have much more specific rules about the exchange of information and cross-border audits.

NON-DISCRIMINATION

One of the hottest issues in the treaty negotiations is understood to have related to the non-discrimination issue—the desire by the United States to ensure that its nationals, and their subsidiaries in Canada, were treated no less favourably than Canadian nationals and their companies. This has been resisted by Canada, which "reserved" on the non-discrimination clause in the draft OECD Model Treaty, and is generally committed to a program of favouring Canadian investors in the Canadian economy. One possible solution would be for the United States to recognize a limited number of situations in which Canada could discriminate in favour of its own nationals, in such areas as having the lower rate of tax on the first $150,000 of corporate business income remain only available to corportions controlled by Canadians.

OTHER ISSUES

There are a number of other points that have been covered in the discussions between the two countries.

It is understood for example, that consideration was given to extending the new treaty to cover Puerto Rico.

A special tax status of professors, teachers and students under the treaty would end.

The treaty will generally be only prospective in its application.

The treaty will contain a number of dollar limitations, but as a reluctant concession to the facts of everday living, these will be indexed annually by a composite cost of living factor.

TREATY INTERPRETATION

There has recently been an interesting tax case in Canada relating to the interpretation of the treaty. In 1976, the Income Tax Act of Canada was amended to impose a withholding tax on loan guarantees paid by Canadians to non-residents of Canada. This was achieved by including such guarantee fees in the definition of "interest" and thus making them subject to a withholding tax. In the recent case of *Associates Corporation of North America,* 80 DTC 6140, the Federal Court of Appeal considered the practice of withholding taxes to guarantee fees paid by a Canadian corporation to a U.S. corporation. The appellate court held that because of the provisions of the Canada-U.S. tax treaty, Canada could not, in the case of an American recipient, declare that the taxpayer's guarantee fees constituted interest income. Rather, such guarantee fees were for the purposes of the treaty, really industrial or commercial profits and hence Canada could not tax such fees where the recipient U.S. corporation did not have a permanent establishment in Canada.

This case is important in that it provides substantial support for the argument that, at least under Canadian jurisprudence, it is not possible for one party to an international tax treaty to modify significantly the application of the treaty by redefining some of the words in the treaty under domestic law. By analogy, Canada might have equal difficulty in applying certain of its new rules relating to the disposition of resource property, for example, to American taxpayers.

Speculation and Fact

One could go on speculating for a long time about the provisions that the new treaty may contain. Indeed, if it is ever concluded, it promises to be a wondrous document, noteworthy not only for its impact on the considerable volume of Canadian-American trade and investment, but also for its new directions in treaty draftsmanship.

But the real question is whether in fact it will ever be signed.

It seems at the moment that only a very few main issues remain unresolved between the negotiators—primarily the question of the withholding tax on dividends, some aspects of the non-discrimination argument, and a wide variety of extraneous issues. (The extraneous issues, by the way, include such items as the Canadian denial of a tax deduction for Canadian advertising on U.S. border T.V. stations, and the U.S. tax rules that discourage Americans from attending conventions in Canada, much to the detriment of Montreal bartenders.) The Canadians also apparently wanted some comfort on the "aggressive" application by the United States of Internal Revenue Code Section 482, which the Canadians feel is having a tendency to undermine the Canadian tax base.

The delay in reaching agreement on a final tax treaty reflects the fact that in a difficult world, both governments are increasingly attuned to their own self-interest and narrow economic objectives. The days of any special status for Canada in U.S. international relations are probably gone, and a new tax treaty between the two countries will only emerge if we can achieve a careful balancing of the objectives of both governments.

It must also be noted that a new tax treaty between Canada and the United States will not be an unmixed blessing for taxpayers. Such a treaty would be likely to clear up a number of uncertainties and technical difficulties that have bothered taxpayers in both countries under the present treaty. Nevertheless, the very length and complexity of the new treaty might well contribute some new problems and uncertainties. In addition, it is quite clear that a new treaty would block a number of perceived loopholes, would sharply restrict the capital gains exemption, and would impose higher taxes on some departing Canadians and on some U.S. enterprises in Canada. Clearly, there will be at least a few taxpayers who probably wish the negotiators nothing but bad luck in their deliberations.

Although we have had too many false starts for anyone to get extremely optimistic, there are clear signs that the negotiations between the two countries may be approaching a conclusion. It will certainly take some final quantum leap by both parties to bridge the policy gaps that divide them, but those gaps are perhaps now small enough that such a bridge is not out of the question.

Perhaps one of the signs that the negotiations may be reaching a favourable conclusion is the fact that the vocal and influential border broadcasting lobby in Washington is understood to be hopping mad about the direction in which the treaty negotiations are going. The border broadcasting lobby is of course a group of U.S. television and radio stations located near the border, banded together to oppose the restrictions which Canada has placed on the tax deductibility of Canadian advertising on U.S. T.V. and radio. The border broadcasting group is concerned because it believes that the U.S. Treasury may be prepared to accept a treaty which will *not* deal with the border broadcasting issue, that is to say, that it will leave Canada free to disallow advertising costs on U.S. stations. And again, to rub salt in the wounds, the treaty is also alleged to include provisions, dear to Canada's heart, that would give better tax breaks for U.S. citizens attending conventions in Canada.

If these rumors are true, one might also speculate that Canada is at least contemplating giving way on one or another of the critical issues in the negotiations, including possibly some downward adjustment in the rate of withholding tax on dividends. Of course, these and other speculations as to the possible terms of the new treaty are just that—speculations—and we will have to await the signing of the treaty to find out what the governments have in fact concluded.

Most Canadian and U.S. taxpayers concerned with trans-border tax issues clearly would welcome a new and much more satisfactory tax treaty between the two countries, which would solve a number of current issues and provide more certain rules of the road in trade and investment. It is gratifying that our two governments have come fairly close to agreement. It is to be hoped that the remaining problems can be swept away and a new and reasonable treaty concluded this year.