

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

Scheduled for a Hearing
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INTRODUCTION

This pamphlet,¹ prepared by the staff of the Joint Committee on Taxation, describes the proposed protocol to the existing income tax treaty between the United States and Canada (the “proposed protocol”).² The proposed protocol was signed on September 21, 2007. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed protocol for July 10, 2008.³

Part I of the pamphlet provides a summary of the proposed protocol. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains a brief overview of Canadian tax laws. Part IV provides a discussion of investment and trade flows between the United States and Canada. Part V contains an article-by-article explanation of the proposed protocol. Part VI contains a discussion of issues relating to the proposed protocol.

¹ This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada* (JCX-57-08), July 8, 2008. References to “the Code” are to the U.S. Internal Revenue Code of 1986, as amended. This document is available on the internet at www.jct.gov.

² The proposed protocol is accompanied by official understandings implemented by an exchange of diplomatic notes (collectively, the “diplomatic notes” or “notes”).

³ For a copy of the proposed protocol, see Senate Treaty Doc. 110-15.

I. SUMMARY

The principal purposes of the Convention Between the United States and Canada with Respect to Taxes on Income and on Capital (signed on September 26, 1980, and amended by protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997) (the “treaty”) are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The treaty also is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries.

The proposed protocol modifies several provisions in the existing treaty. The rules of the proposed protocol generally are similar to rules of recent U.S. income tax treaties, the United States Model Income Tax Convention of November 15, 2006 (the “U.S. Model treaty”), and the 2005 Model Convention on Income and on Capital of the Organisation for Economic Cooperation and Development (the “OECD Model treaty”). However, the existing treaty, as amended by the proposed protocol, contains certain substantive deviations from these treaties and models. These deviations are noted throughout the explanation of the proposed protocol in Part V of this pamphlet.

The proposed protocol amends Article III (General Definitions) of the treaty by adding a definition for the term “national” of a treaty country. The term national is relevant for paragraph (1) of Article XXVI (Mutual Agreement Procedure) of the treaty and, as amended by the protocol, paragraph (1) of Article XXV (Non-Discrimination) of the treaty.

The proposed protocol amends Article IV (Residence) of the existing treaty to specifically address companies that are residents of both treaty countries. The proposed protocol provides that if such a company is created under the laws in force in a treaty country but not under the laws in force in the other treaty country, the company is deemed to be a resident only of the first treaty country. If that rule does not apply, the competent authorities of the treaty countries must endeavor to settle the question of residency by mutual agreement and determine the mode of application of the treaty to the company. In the absence of such agreement, the company is not considered to be a resident of either treaty country for purposes of claiming any benefits under the treaty.

The proposed protocol also amends Article IV of the existing treaty to provide specific rules regarding the circumstances in which amounts of income, profit, or gain are deemed to be derived through or paid by fiscally transparent entities. In general, an amount of income, profit, or gain is considered to be derived by a resident of a treaty country if (1) that person is considered under the taxation law of that country to have derived the amount through an entity, other than an entity that is a resident of the other treaty country, and (2) by reason of that entity being treated as fiscally transparent under the laws of the first treaty country, the treatment of the amount under the taxation law of that country is the same as its treatment would be if that amount had been derived directly by that person. Notwithstanding the general rule, an amount of income, profit, or gain is considered not to be paid to or derived by a person who is a resident of a treaty country if (1) that person is considered under the taxation law of the other treaty country as deriving the amount through an entity that is not a resident of the first treaty country, but (2)

by reason of the entity not being treated as fiscally transparent under the laws of that treaty country, the treatment of the amount under the taxation law of that country is not the same as its treatment would be if that amount had been derived directly by the person. Additionally, an amount of income, profit, or gain is not considered to be paid to or derived by a person who is a resident of a treaty country if (1) the person is considered under the tax law of the other treaty country to have received the amount from an entity resident in the other treaty country, but (2) by reason of the entity being treated as fiscally transparent under the laws of the first treaty country, the treatment of the amount received by that person under the tax law of that country is not the same as its treatment would be if the entity were treated as not fiscally transparent under the laws of that country.

The proposed protocol amends Article V of the existing treaty to add a special rule under which services performed by an enterprise of a treaty country in the other treaty country may give rise to a permanent establishment in the other country if the enterprise exceeds certain levels of presence in the other country and if certain other conditions are met.

The proposed protocol applies the treaty partners' interpretation of the arm's-length standard in a manner consistent with the OECD Transfer Pricing Guidelines to the attribution of profits to a permanent establishment in under Article VII, taking into account the different economic and legal circumstances of a single legal entity. Under the proposed protocol, the business profits to be attributed to a permanent establishment include only the profits derived from the assets used, risks assumed, and activities performed by the permanent establishment. The proposed protocol also amends Article VII of the existing treaty to clarify that income may be attributable to a permanent establishment that no longer exists in one of the treaty countries. In addition, the proposed protocol provides that income derived from independent personal services (i.e., income from the performance of professional services and of other activities of an independent character) is included within the meaning of the term "business profits." Accordingly, the treatment of such income is governed by Article VII rather than by present treaty Article XIV (Independent Personal Services), which the proposed protocol deletes. These new rules are similar to provisions included in other recent U.S. treaties and protocols, including the U.S Model treaty.

The proposed protocol modifies Article X (Dividends) of the present treaty to more closely reflect the dividend provisions included in the U.S. Model treaty and recent U.S. income tax treaties. The modifications include a revised definition of the term "dividends" and an updated special rule that applies to dividends paid by U.S. REITs.

The proposed protocol replaces Article XI (Interest) of the present treaty with a new article that generally provides for exclusive residence-country taxation of interest. Limited exceptions permit source-country taxation of interest if the beneficial owner of the interest carries on, or has carried on, business through a permanent establishment in the source country and the debt-claim in respect of which the interest is paid is effectively connected with that permanent establishment. Two anti-abuse provisions relating to contingent interest payments and residual interests in real estate mortgage investment conduits also permit source-country taxation of interest. Special rules apply to cases involving a non-arm's-length interest charge between a payer and a beneficial owner that have a special relationship.

The proposed protocol conforms Article XII (Royalties) to the proposed elimination of Article XIV (Independent Personal Services) and clarifies the treatment of income attributable to a permanent establishment that has ceased to exist.

The proposed protocol modifies Article XIII (Gains) of the present treaty in two principal respects. First, the proposed protocol narrows the emigration exception to the Article's rule providing for exclusive residence-country taxation of gains from the alienation of property in cases other than those specifically enumerated in Article XIII. The proposed protocol provides that this exception will not apply if the property was treated as alienated immediately before an individual's emigration. Second, the proposed protocol provides a revised election intended to coordinate U.S. and Canadian taxation of gains in the case of timing mismatches.

The proposed protocol conforms Article XV (Dependent Personal Services) of the present treaty to the U.S. and OECD Model treaties, as well as to the proposed elimination of Article XIV (Independent Personal Services), and broadens the definition of "remuneration." In addition, the proposed protocol changes the rules with respect to calculating the number of days an individual is present in the other treaty country for purposes of determining if a resident of one treaty country may be taxed by the other treaty. The proposed protocol also contains provisions intended to eliminate potential abuses through the use intermediary employers. The diplomatic notes exchanged in connection with the proposed protocol set forth new rules for allocating income from the exercise or disposal of an option between the two treaty countries.

The proposed protocol makes certain conforming changes to Article XVI (Artistes and Athletes) of the treaty.

The proposed protocol modifies some of the existing treaty rules of Article XVIII (Pensions and Annuities) of the present treaty, mostly to address Roth individual retirement accounts, and adds several new provisions that address cross-border pension contributions and benefits accruals. Many of the new rules are similar to those found in the U.S. Model treaty, but several reflect the uniquely large cross-border flow of personal services between Canada and the United States, including the large number of cross-border commuters. These rules are intended to remove barriers to the flow of personal services between the two countries that could otherwise result from discontinuities under the laws of each country regarding the deductibility of pension contributions and the taxation of a pension plan's earnings and accretions in value. In addition, the proposed protocol adds a new provision to address the source of certain annuity or life insurance payments made by branches of insurance companies.

The proposed protocol makes certain conforming changes to Article XIX (Government Service) of the treaty.

The proposed protocol replaces Article XX (Students) of the present treaty with a new article that generally corresponds to the treatment provided under the present treaty. The proposed protocol adds a one-year limitation on the exemption from income tax in the host country in the case of apprentices and business trainees.

The proposed protocol modifies Article XXI (Exempt Organizations). The new rules are intended to permit charitable-type organizations to invest indirectly and to pool their investments with pension-type organizations.

The proposed protocol adds a new paragraph to Article XXII (Other Income) of the treaty for guarantee fees. The new paragraph provides that compensation derived by a resident of a contracting state in respect of a guarantee of indebtedness shall be taxable only in that state, unless the compensation is business profits attributable to a permanent establishment in the other contracting state, in which case Article VII (Business Profits) shall apply.

The proposed protocol changes the obligations of Canada under Article XXIV (Elimination of Double Taxation) of the treaty with respect to dividends received by a Canadian company from a U.S. resident company. Under the proposed protocol, a Canadian company receiving a dividend from a U.S. resident company of which it owns at least 10 percent of the voting stock, a credit against Canadian income tax of the appropriate amount of income tax paid or accrued to the United States by the dividend paying company with respect to the profits out of which the dividends are paid.

The proposed protocol revises the general rules of Article XXV (Non-Discrimination) of the present treaty to bring those rules into closer conformity with the U.S. Model treaty and recent U.S. income tax treaties. The proposed protocol generally prohibits a treaty country from discriminating against nationals of the other treaty country by imposing on those nationals more burdensome taxation than it imposes or may impose on its own nationals in the same circumstances.

The proposed protocol changes the voluntary arbitration procedure of Article XXVI (Mutual Agreement Procedure) of the treaty to a mandatory arbitration procedure that is sometimes referred to as “last best offer” arbitration, in which each of the competent authorities proposes one and only one figure for settlement, and the arbitrator must select one of those figures as the award. Under the proposed protocol, unless a taxpayer or other “concerned person” (in general, a person whose tax liability is affected by the arbitration determination) does not accept the arbitration determination, it is binding on the treaty countries with respect to the case. The mandatory and binding arbitration procedure is included in the U.S. treaties with Germany and Belgium.

The proposed protocol modifies Article XXVI A (Assistance in Collection) of the present treaty to further limit, in a narrow class of cases, one treaty country’s obligation to assist the other treaty country in collecting taxes. The modifications also explicitly provide that the assistance-in-collection provisions apply to contributions to social security and employment insurance premiums levied by or on behalf of the government of a treaty country.

The proposed protocol replaces Article XXVII (Exchange of Information) of the present treaty with rules similar to those in the U.S. Model treaty. The proposed rules generally provide that the two competent authorities will exchange such information as may be relevant in carrying out the provisions of the domestic laws of the United States and Canada concerning taxes to which the treaty applies to the extent the taxation under those laws is not contrary to the treaty.

The proposed protocol amends the saving clause in Article XXIX (Miscellaneous Rules) to bring the treaty generally in conformity with the U.S. taxation of former citizens and former long-term residents under section 877 of the Code. The proposed protocol provides that notwithstanding the other provisions of the treaty, a former citizen or former long-term resident of the United States, may, for a period of ten years following the loss of such status, be taxed in accordance with the laws of the United States with respect to income from sources within the United States (including income deemed under the domestic law of the United States to arise from such sources).

The proposed protocol replaces Article XXIX A (Limitation on Benefits) of the present treaty with a new article that reflects the anti-treaty-shopping provisions included in the U.S. Model treaty and more recent U.S. income tax treaties. The rules in the present treaty are not reciprocal and may be applied only by the United States. The new rules are reciprocal and are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits solely by reason of residence in Canada or the United States.

The proposed protocol replaces Article XXIX B (Taxes Imposed by Reason of Death) of the present treaty with a new article that generally addresses certain concerns regarding the application of Canadian tax rules and regarding the availability of tax credits or deductions when the United States and Canada impose tax on the same items of income or property.

Article 27 of the proposed protocol provides for the entry into force of the proposed protocol. The provisions of the proposed protocol are generally effective on a prospective basis. However, the provisions with respect to dual-residence tie breakers (Article 2 of the proposed protocol) and an emigrant's gain (Article 8 of the proposed protocol) are effective retroactive to September 17, 2000. In certain situations, the reduction of interest withholding rates is also retroactive, with the initial phase-in rate applicable for the year in which the proposed protocol becomes effective. Also, the provisions for assistance in the collection of taxes are retroactively effective to revenue claims that have been definitively determined after November 9, 1985.

With respect to certain payments through fiscally transparent entities and the new provisions regarding permanent establishments, the proposed protocol is effective as of the first day of the third year that ends after the proposed protocol enters into force. Special rules apply for determining when to start counting (1) days present, (2) services rendered, and (3) gross active business revenues for purposes of the permanent establishment provision. With respect to the arbitration provisions, the proposed protocol clarifies that a competent authority matter currently in progress will be deemed to have started on the date on which the proposed protocol enters into force.

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

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

A. U.S. Tax Rules

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

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

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

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the

United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real property.

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

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

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

B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

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

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

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

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

country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. The Internal Revenue Service (the “IRS”), and the treaty partner’s tax authorities, also can request specific tax information from a treaty partner. These requests can include information to be used in a criminal investigation or prosecution.

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

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

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

III. OVERVIEW OF TAXATION IN CANADA⁴

A. National Income Taxes

Overview

Canada imposes a national income tax on the income of individuals and companies.⁵ In addition, provincial taxes are imposed on the income from activity within the provinces.⁶ Nonresidents are taxed on Canadian-source income. The Canadian corporate tax system attempts to alleviate the double taxation of income through the implementation of a modified imputation system, which provides a tax credit with respect to dividends paid by domestic corporations to individuals.

Individuals

Individuals resident in Canada are subject to tax on their worldwide income.⁷ Each individual must separately compute his or her tax liability, and family members may not file joint income tax returns.⁸ Gross income is divided into several categories, including employment income, business income, property income, and capital gains.⁹ Property income consists of passive income earned through investment activities.¹⁰ In computing gross income, resident taxpayers determine their income and losses for each category separately.¹¹ All sources of income are then aggregated before the taxpayer calculates taxable income.¹² For 2008, individuals pay income tax at graduated marginal rates ranging from 15 percent on taxable

⁴ The information in this section relates to foreign law and is based on the Joint Committee staff's review of publicly available secondary sources, including in large part Patrick Marley & Richard Tremblay, *Business Operations in Canada*, Tax Management Portfolio No. 955-4th [hereinafter *TMP Canada*]; IBFD European Taxation Analysis, Canada, available at <http://checkpoint.riag.com> [hereinafter *IBFD Canada Country Survey*]. The description is intended to serve as a general overview; it may not be fully accurate in all respects, as many details have been omitted and simplifying generalizations made for ease of exposition.

⁵ *IBFD Canada Country Survey* Intro.

⁶ *Id.*

⁷ *IBFD Canada Country Survey* B.1.2.1.

⁸ *IBFD Canada Country Survey* B.1.1.

⁹ *IBFD Canada Country Survey* B.1.2.1.

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

income not exceeding CAD 37,885 (U.S. \$38,605) to 29 percent on taxable income in excess of CAD 123,184 (U.S. \$125,524).¹³ Individuals also are subject to an alternative minimum income tax.¹⁴

Individual taxpayers are entitled to deductions for a limited number of personal expenses, including for childcare expenses incurred to allow the individual to work or obtain education.¹⁵ The spouse with the lower taxable income must claim the deduction if both spouses work.¹⁶ Individuals may also claim a number of credits, which are calculated by multiplying an allowance by the lowest tax rate. A basic personal credit of 15 percent of CAD 9,600 (U.S. \$9,782) is available to unmarried individuals with no dependents. A married taxpayer whose only dependent is a spouse with no income may claim a credit equal to 15 percent of CAD 19,200 (U.S. \$19,565); the credit is reduced by 15 percent of the spouse's income and is eliminated once the spouse's income exceeds CAD 9,600 (U.S. \$9,782).¹⁷ Individuals may also claim credits for certain medical expenses, employment taxes, and donations to charities.¹⁸

Dividends, interest, and royalties are subject to tax, and the expenses incurred to produce investment income generally are deductible.¹⁹ Dividends paid by domestic companies are taxable at a reduced rate.²⁰ An individual's effective tax rate on dividends depends on the province and generally is equal to that on capital gains. The rate reduction is accomplished by means of an imputation tax credit under which a shareholder is permitted a credit on the grossed-up dividend. The gross-up amount equals one-fourth of the dividend and theoretically represents the corporate income subject to corporate-level tax. The dividend credit amount, which is based on the gross amount of the dividend, represents the corporate tax paid on the distributed dividend. One half of capital gains are included in income, and a Canadian resident is entitled to an exemption of up to CAD 750,000 (U.S. \$764,246) (under the government's 2007 budget, an increase from the previous CAD 500,000 amount) over his lifetime on gain from the disposition of either a qualifying farm or shares of a Canadian-controlled private corporation that uses

¹³ The quoted tax rates and threshold amounts apply in 2008. U.S. dollar equivalents were calculated using the currency rate for January 1, 2008 according to OANDA's FX Converter, available at <http://www.oanda.com>.

¹⁴ *IBFD Canada Country Survey* B.1.9.1.

¹⁵ *IBFD Canada Country Survey* B.1.7.1.

¹⁶ *Id.*

¹⁷ *IBFD Canada Country Survey* B.1.7.3.

¹⁸ *Id.*

¹⁹ *IBFD Canada Country Survey* B.1.5.

²⁰ *Id.*

substantially all its assets in carrying on an active business primarily in Canada.²¹ Fisherman are entitled to a similar exemption.²² Capital gains arising from the disposition of principal residences and personal-use assets (subject to a cap) and compensation or damages received for personal injury are also exempt.²³

Corporations

Corporations resident in Canada are taxable on their worldwide income from business income, property income, and capital gains.²⁴ Property income consists of passive income earned through investment activities. Business income is taxable at full rates, property income is generally taxable at full rates with certain exceptions for dividends, and 50 percent of capital gain is included in income. Expenses are generally deductible to the extent they are reasonable and incurred for the purpose of gaining or producing income, and, if related to capital structure (i.e., an amount deducted with respect to an outlay, loss, or replacement of capital),²⁵ to the extent the deduction is expressly permitted by the Income Tax Act. Expenses are not deductible if they are incurred for the purpose of gaining or producing exempt income or if they are incurred solely for the purpose of realizing capital gains.²⁶ In general, financing expenses, royalties, and intercorporate dividends are deductible. Interest expense that is on capital account is deductible only in accordance with statutory rules.

Canada levies taxes at both the individual and the shareholder level, and double taxation is partially eliminated through a modified imputation system.²⁷ As discussed above, a notional dividend tax credit provides tax relief with respect to domestic dividends paid to individuals. This credit does not fully compensate for corporate tax paid in the case of active business income of a Canadian-controlled private corporation in excess of an annual limit, income earned by a publicly traded domestic corporation, income earned by a nonresident controlled corporation, or income earned by a publicly traded domestic corporation. For dividends paid by resident public corporations after 2005, an enhanced gross-up and dividend tax credit is available.²⁸

²¹ *IBFD Canada Country Survey* B.1.6; Canada Revenue Agency, “What’s New for Capital Gains,” available at <http://www.cra-arc.gc.ca/tax/individuals/topics/income-tax/return/completing/reporting-income/lines101-170/127/new-e.html> (last accessed July 1, 2008).

²² *TMP Canada* at A-57.

²³ *IBFD Canada Country Survey* B.1.6.

²⁴ *IBFD Canada Country Survey* A.1.3.1.

²⁵ *TMP Canada* at A-46 to A-47.

²⁶ *IBFD Canada Country Survey* A.1.3.3.1.

²⁷ *IBFD Canada Country Survey* A.1.1.

²⁸ *Id.*

Corporate entities resident in Canada are generally subject to tax on their worldwide income at rates that depend on the status of the corporation and the type and location of income earned.²⁹ A corporation is considered to be a Canadian resident if it was incorporated in Canada or, if incorporated outside Canada, its central management and control is located in Canada.³⁰ The general federal corporate rate is 38 percent, and for income earned in any Canadian province, a 10 percent rebate applies.³¹ A four percent surtax on all corporations has been eliminated as of January 1, 2008. Additionally, in 2008 an 8.5 percent reduction applies to corporate income earned in a Canadian province that does not currently benefit from other preferential tax treatment.³² This reduction is scheduled to increase to nine percent in 2009, to 10 percent in 2010, to 11.5 percent in 2011, and to 13 percent in 2012 and subsequent years. Types of income not eligible for the reduced rate because they currently benefit from preferential treatment include: investment income earned by Canadian-controlled private corporations; income earned by mutual fund corporations, mortgage investment corporations, and investment corporations; Canadian manufacturing and processing income; and income from nonrenewable natural resource activities. Thus, the general effective federal corporate tax rate is 19.5 percent for 2008. This rate will be reduced to 19 percent beginning January 1, 2009, and to 18 percent beginning January 1, 2010.³³

Corporate groups are not permitted to file consolidated tax returns, but special rules govern the treatment of intra-group income.³⁴ Dividends are includible in income, and a corporation generally may claim an offsetting deduction to the extent it receives dividends from a taxable resident corporation.³⁵ The deduction is not available for preferred shares more similar to debt than equity. A tax may be imposed on dividends on preferred shares if the corporation paying the dividend has not paid a minimum level of tax on the income generating the dividend. Capital gains treatment may apply to an otherwise deductible intercorporate dividend in certain situations.³⁶ A refundable tax equal to one-third of dividends received must be paid by private and certain other closely held corporations unless the recipient corporation controls or owns at least 10 percent of the votes and value of the payer corporation. The tax is refunded when a

²⁹ *IBFD Canada Country Survey* A.1.6.1.

³⁰ *IBFD Canada Country Survey* A.1.2.1.

³¹ *IBFD Canada Country Survey* A.1.6.1.

³² *TMP Canada* at A-66 to A-67.

³³ *IBFD Canada Country Survey* A.1.6.1.

³⁴ *IBFD Canada Country Survey* A.2.1.

³⁵ *IBFD Canada Country Survey* A.2.2.

³⁶ *Id.*

taxable dividend is paid by the corporation to a corporate or noncorporate shareholder. For every CAD 3 (U.S. \$3) of dividend paid, CAD 1 (U.S. \$1) of refund is granted.³⁷

³⁷ *Id.*

B. International Aspects of Taxation in Canada

Individuals

Individuals resident in Canada generally are taxed on their worldwide income and capital gains.³⁸ An individual is considered a resident if he or she resides or is ordinarily resident in Canada. Foreign income and capital gains are subject to the same federal taxes as domestic income. A federal surtax is also imposed on foreign income, but no provincial taxes apply. Foreign-source dividends, interest, royalties, and rental income are fully taxable, and individuals receiving foreign-source dividends receive no imputation credit. Nonresidents are subject to tax only on certain Canadian-source income. Nonresidents who earn income from employment, business, or capital gains in Canada must file a Canadian tax return and pay tax at the same rates as a resident. In the absence of a treaty, nonresidents who earn Canadian-source dividends, interest, royalties, and rental income are subject to a flat 25-percent withholding tax on gross income.³⁹ The income will be taxed as business income, however, if the income is business income of a permanent establishment in Canada.

Corporations

Companies resident in Canada generally are taxed on their worldwide income and capital gains.⁴⁰ The 10-percent federal rate reduction is not available for foreign income not considered to be earned in a province or territory. Nonresident corporations generally are subject to tax on certain items of income from carrying on a business in Canada at the general Canadian tax rates. Nonresidents are considered to be carrying on business in Canada if they produce, grow, mine, create, manufacture, fabricate, improve, pack, preserve, or construct anything in Canada, or if they solicit orders or offers anything for sale in Canada through an agent or servant.⁴¹ Nonresident corporations are also subject to a branch profits tax of 25 percent of Canadian-earned taxable income, after certain deductions are taken. The branch tax is intended to replicate the dividend withholding tax that would be imposed if a foreign corporation operated in Canada through a subsidiary rather than a branch, and the tax generally is reduced to the extent that a tax treaty reduces the dividend withholding tax rate.

Dividends, interest, rental payments, and royalties paid to nonresidents generally are subject to a 25-percent withholding tax.⁴² The income will be taxed as business income rather than through withholding if it relates to a business carried on in Canada through a permanent establishment. In computing income for withholding tax purposes, no deductions may be

³⁸ *IBFD Canada Country Survey* B.6.1.1.

³⁹ *IBFD Canada Country Survey* B.6.3.3.

⁴⁰ *IBFD Canada Country Survey* A.6.1.1.

⁴¹ *IBFD Canada Country Survey* A.6.2.1.1.

⁴² *IBFD Canada Country Survey* A.6.3.

claimed. Nonresidents earning income subject to withholding are not required to file a tax return. With regard to interest income, exemptions from withholding apply to: (1) interest payable on certain bonds, debentures, notes, and mortgages that were issued or guaranteed by the Canadian government; (2) interest payable on obligations issued by the Canadian provinces, municipalities, or agencies of the federal or provincial governments; (3) interest payable on debt issued by educational institutions or hospitals and guaranteed by a province; and (4) interest paid on five-year debt by a resident corporation to an arm's-length recipient, so long as the interest is not dependent on profits.⁴³ With regard to royalties, no withholding tax applies for certain copyright payments, payments for research and development expenses made under cost-sharing arrangements in which the payer acquires an interest in the research, and arm's-length payments where the payer is entitled to a deduction in computing income from a business carried on outside Canada.⁴⁴

Nonresidents that dispose of taxable Canadian property are subject to capital gains tax. Taxable property includes Canadian real estate, shares of Canadian resident private corporations and certain nonresident corporations (provided that Canadian real estate or assets have, at any time in the previous year, accounted for at least half the fair market value of all the corporation's assets), interests in certain partnerships, and capital assets used in carrying on a business in Canada.⁴⁵

In the absence of a treaty, Canada generally provides double tax relief by way of a credit for foreign taxes paid against Canadian tax.⁴⁶ Separate credits are available for foreign nonbusiness income tax and for foreign business income tax. The credit must be computed separately for each foreign country in an amount based on the income earned in that country as a percentage of world income. The foreign tax credit is limited to the amount of Canadian tax that would otherwise be paid on the foreign income. For individuals, the credit is limited to 15 percent of foreign taxes paid on foreign income from interest, royalties, and dividends.

⁴³ *IBFD Canada Country Survey* A.6.3.1.

⁴⁴ *IBFD Canada Country Survey* A.6.3.3.

⁴⁵ *IBFD Canada Country Survey* A.6.2.1.2.

⁴⁶ *IBFD Canada Country Survey* A.6.1.3.1.

C. Other Taxes

Taxes on income and capital

Each province imposes a provincial corporate income tax. Canadian municipalities may impose business license fees but do not impose income taxes. The provinces impose royalties or taxes on income from oil, gas, and mining operations.⁴⁷

The federal government imposes capital taxes on financial institutions and on life insurance corporations. The capital taxes effectively are a form of minimum tax, and income taxes and corporate surtaxes may be credited against them. Corporations generally may carry over unused credits from other years to reduce capital taxes due.

Canadian provinces also impose real estate taxes, typically at the municipal government level, and capital taxes on corporations with a permanent establishment in the province.

Inheritance and gift taxes

Though Canada imposes no gift or inheritance tax on its residents, deemed disposition provisions impose a form of such taxes. A person gifting property to another individual is deemed to have received proceeds equal to the fair market value of the gifted property, which may cause the donor to recognize income, recaptured depreciation, or capital gains. Similar rules apply to dispositions on death. Spouses may transfer property to each other either by gift or on death without triggering a deemed receipt of proceeds.

Payroll taxes

Several Canadian provinces impose payroll taxes, which are used to finance social insurance programs, at rates ranging from one to 4.26 percent. Employees must contribute, up to maximum annual limits, to a federal unemployment insurance fund and pension plan that provides retirement, disability, and certain other benefits. Every month, employers are responsible for collecting and remitting the employees' portions, as well as their own portions. The provinces each administer their own general health insurance and accident plans to assist residents with the cost of health care and to compensate employees who have been injured at work.

Indirect taxes

Canada imposes a form of a value added tax known as the goods and services tax ("GST"). The tax generally applies to all domestic transactions, including certain transfers of real estate. The tax also applies to imported goods; imported services are subject to the tax if the service recipient is not registered for GST purposes. The GST is charged at each stage of the economic chain, and vendors are able to claim refunds in the form of input tax credits of tax paid. Because the final consumer is not able to claim an input tax credit for GST paid, the tax is

⁴⁷ *IBFD Canada Country Survey A.5.1.*

ultimately borne by the final customer. The standard rate is six percent. Certain goods and services, such as food, medical devices, some agriculture and fishing products, residential rents, most health and dental services, certain educational services, domestic financial services, and the sale of previously owned residential housing, are exempt. Goods and services exported outside Canada are also exempt.

Several Canadian provinces impose a tax on transfers of real property. Rates range to up to two percent of the amount paid for the property.

IV. THE UNITED STATES AND CANADA: CROSS-BORDER INVESTMENT AND TRADE

A. Introduction

A principal rationale for negotiating tax treaties is to improve the business climate for business persons in one country who might aspire to sell goods and services to customers in the other country and to improve the investment climate for investors in one country who might aspire to own assets in the other country. Clarifying the application of the two nations' income tax laws makes more certain the tax burden that will arise from different transactions, but may also increase or decrease that burden. Where there is, or where there is the potential to be, substantial cross-border trade or investment, changes in the tax structure applicable to the income from trade and investment has the potential to alter future flows of trade and direct investment. Therefore, in reviewing the proposed protocol it may be beneficial to examine the cross-border trade and investment between the United States and Canada.

When measuring by trade in goods or services or when measuring by direct and non-direct cross-border investment, the United States and Canada are important components of each country's current and financial accounts. In 2007, aggregate cross-border investment between the United States and Canada exceeded \$140 billion. Substantial cross-border investment by persons in both countries over the years has resulted in cross-border income flows generally in excess of \$30 billion (real 2007 dollars) annually since 1995. The income from cross-border trade and investment generally is subject to income tax in either the United States or Canada and in many cases the income is subject both to gross basis withholding taxes and net basis income tax in the residence country.

B. Overview of International Transactions Between the United States and Canada

The value of trade between the United States and Canada is large. In 2007, the United States exported \$248.9 billion of goods to Canada and imported \$317.1 billion in goods from Canada.⁴⁸ These figures made Canada the United States' leading goods export destination and the second largest source of imported goods. These figures also represent 21.7 percent of all goods exports from the United States and 16.1 percent of all imports into the United States. Similarly, the value of cross-border investment, U.S. investments in Canada, and Canadian investments in the United States is large. In 2007, U.S. investments in Canada increased by \$67.2 billion and Canadian investments in the United States increased by \$73.7 billion.⁴⁹ The increase in Canadian-owned U.S. assets represents approximately 3.6 percent of the increase in all foreign-owned assets in the United States in 2007. Table 1, below, summarizes the international transactions between the United States and Canada in 2007.

Table 1 presents the balance of payments accounts between the United States and Canada. Two primary components comprise the balance of payments account: the current account and the financial account.⁵⁰ The current account measures flows of receipts from the current trade in goods and services between the United States and Canada and the flow of income receipts from investments by U.S. persons in Canada and by Canadian persons in the United States. The financial account measures the change in U.S. investment in Canada and the change in Canadian investment in the United States.

⁴⁸ Bureau of Economic Analysis, U.S. Department of Commerce, "U.S. International Trade in Goods and Services, Annual Revision for 2007," June 10, 2008.

⁴⁹ Bureau of Economic Analysis, U.S. Department of Commerce, "International Economic Accounts," www.bea.gov/international, June 17, 2008. Preliminary data.

⁵⁰ The U.S. Department of Commerce, Bureau of Economic Analysis reports and describes international transactions by reference to a three-group classification to make U.S. data reporting more closely aligned with international guidelines. The three groups are labeled, as in Table 1: current account; capital account; and financial account. The current account measures flows of receipts from the current trade in goods and services between the United States and abroad and the flow of income receipts from investments by U.S. persons abroad and by foreign persons in the United States. Income receipts also include compensation of employees based abroad. The financial account measures U.S. investment abroad and foreign investment in the United States. The capital account consists of capital transfers and the acquisition and disposal of non-produced, non-financial assets. For example, the capital account includes such transactions as forgiveness of foreign debt, migrants' transfers of goods and financial assets when entering or leaving the country, transfers to title to fixed assets, and the acquisition and disposal of non-produced assets such as natural resource rights, patents, copyrights, and leases. In practice, the Bureau of Economic Analysis believes the capital account transactions will be small in comparison to the current account and financial account.

Table 1.—International Transactions Between the United States and Canada, 2008
(\$ billions, nominal)

Current Account Balance	-37.3
Exports of Goods and Services from the United States and income receipts from Canada	338.4
Merchandise	249.7
Services	43.3
Income receipts from U.S. assets ¹	45.3
Imports of goods and services from Canada and income payments to Canada	374.0
Merchandise	320.3
Services	25.2
Payments on Canadian-owned U.S. assets ¹	28.0
Unilateral Transfers	-1.7
Financial Account Balance	3.6
Canadian Investment in the United States ²	73.7
Direct Investment	36.9
Private non-direct investment	38.3
Official	0.7
U.S. Investment in Canada ²	67.2
Direct Investment	22.8
Private non-direct investment ¹	44.4
Increase in government assets	0.0
Capital Account Transactions, net	0.2
Statistical Discrepancy	33.6

Notes:

¹ In the national income and product accounts the “income” entry of the current account also includes certain employee compensation income. Table 1 excludes \$154 million of compensation paid by Canadian persons to U.S. residents employed temporarily in Canada and U.S. workers who commute to work in Canada (and U.S. residents employed by the Canadian embassy and \$531 million of compensation paid by U.S. persons to Canadian residents employed temporarily in the United States and Canadian workers who commute to work in the United States (and Canadian residents employed by the U.S. embassy in Canada).

² Excluding financial derivatives.

Source: Bureau of Economic Analysis, U.S. Department of Commerce, June 17, 2008. Preliminary data.

C. Trends in Current Account Income Flows Between the United States and Canada

Payments of Royalties

As Table 1 displays, the current account consists of three primary components: trade in goods; trade in services; and payment of income on assets invested abroad. Numerous disparate activities comprise trade in services. Among the sources of receipts from exported services are transportation of goods; travel by persons and passenger fares; professional services such as management consulting, architecture, engineering, and legal services; financial services; insurance services; computer and information services, and film and television tape rentals. Also included in receipts for services are the returns from investments in intangible assets in the form of royalties and license fees. In 2006, U.S. persons received approximately \$5.1 billion in royalties and license fees from Canada.⁵¹ In 2006, Canadian persons' payments of royalties and license fees constituted 8.1 percent of all such payments to the United States. Canada ranked as the fourth largest payor of royalties and license fees among all U.S. trading partners.⁵² In 2006, Canadian persons received \$0.9 billion in royalties and license fees from the United States.⁵³ These U.S. payments of royalties and license fees constituted 3.2 percent of all such payments made by U.S. persons. Figure 1 documents the cross-border payments of royalties and license fees between the United States and Canada measured in constant dollars.⁵⁴ The aggregate amount of such cross-border flows has grown from less than \$1.3 billion in 1986 (measured in real 2007 dollars) to \$7.0 billion in 2007.

⁵¹ Jennifer Koncz and Anne Flatness, "U.S. International Services, Cross-Border Trade in 2006 and Sales Through Affiliates in 2005," *Survey of Current Business*, Vol. 87, October 2007, p.101.

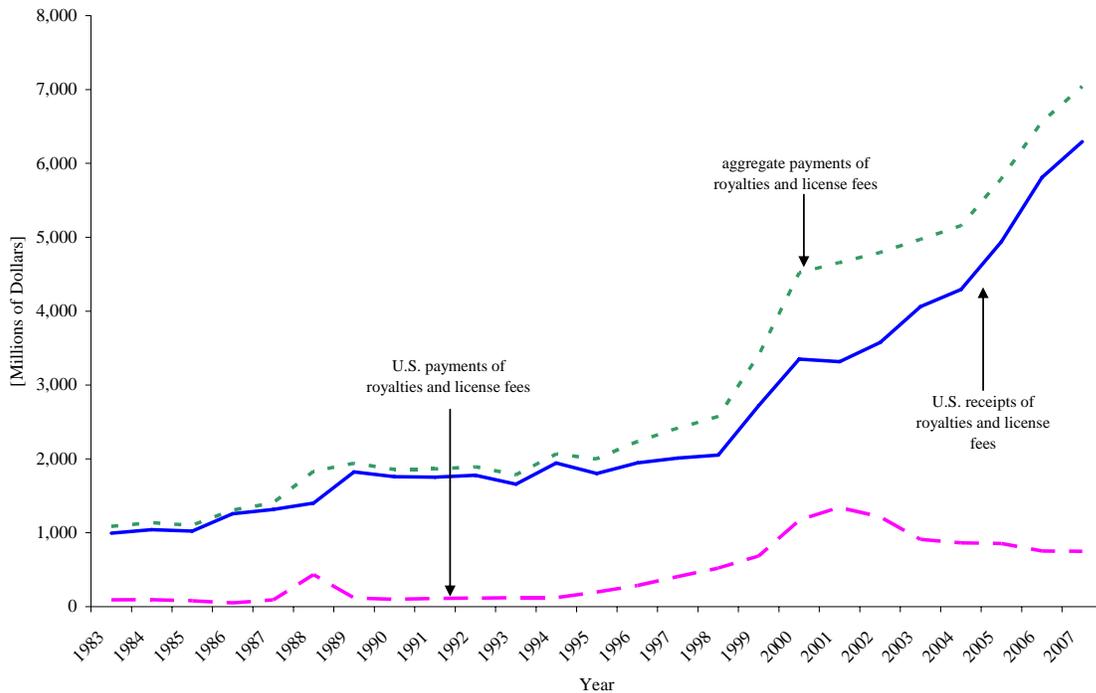
⁵² *Ibid.* The four countries providing larger total payments of royalties and license fees in 2006 were Japan, the United Kingdom, and Switzerland.

⁵³ *Ibid.*

⁵⁴ In Figure 1 through Figure 3 a solid line represents payments to the United States from Canada and a heavy broken line represents payments from the United States to Canada. Figure 1 and Figure 2 also have a lighter broken line representing the sum of payments from Canada and from the United States.

**Figure 1.—U.S. and Canadian Payments of Royalties and License Fees,
1993-2007**

[Millions of Real 2007 Dollars]



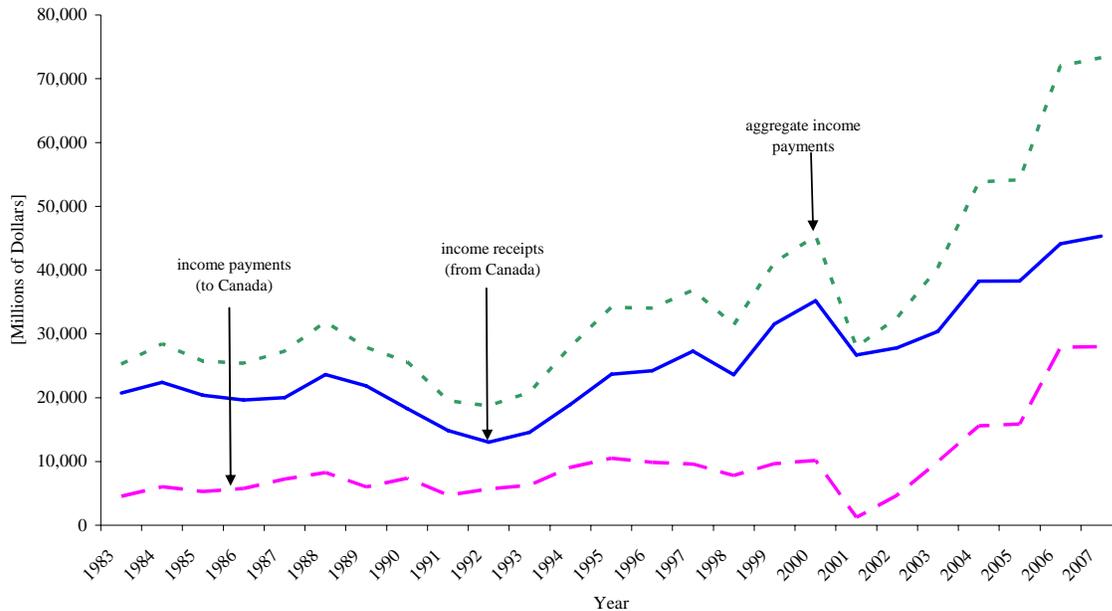
Income receipts from investments

Overview

Figure 2 shows the growth in cross-border receipts between the United States and Canada that has occurred in cross-border payments of income from Canadian assets owned by U.S. persons and from U.S. assets owned by Canadian persons. Measured in real dollars, income received by U.S. persons from the ownership of assets in Canada has more than doubled since 1986. Over the same period, income received by Canadian persons from the ownership of assets in United States has also grown more than fourfold.

**Figure 2.—U.S. and Canadian Receipts of Income from Investments,
1983-2007**

[Millions of Real 2007 Dollars]



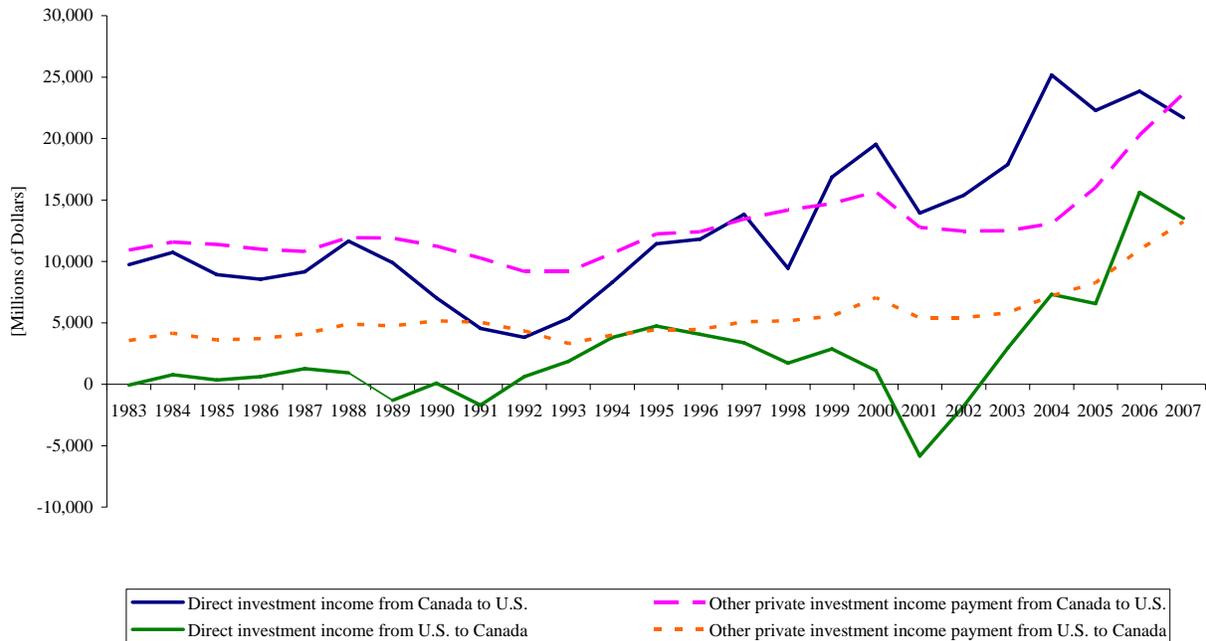
Income from direct investment and income from non-direct investment

Income from foreign assets is categorized as income from “direct investments” and income from “non-direct investments.” Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interest in an unincorporated business. Often the income that crosses borders from direct investments is in the form of dividends from a subsidiary to a parent corporation, although interest on loans between such related corporations is another source of income from a direct investment. In non-direct investments, the investor generally does not have control over the assets that underlie the financial claims. Non-direct investments consist mostly of holdings of corporate equities and corporate and government bonds, generally referred to as “portfolio investments,” and bank deposits and loans. Hence, the income from non-direct investments generally is interest or dividends.

In 2007, the income received by Canadian persons from direct investments in the United States totaled \$13.5 billion and the income received by Canadian persons from portfolio (non-governmental) and other non-direct investments in the United States totaled \$13.2 billion. Canadian persons also received more than \$1 billion in income from payments from the U.S. government, largely interest on U.S. government obligations held by Canadian persons.

In 2007, the income of U.S. persons from direct investments in the Canada was roughly 60 percent greater than the income received by Canadian persons on their direct investments in the United States (\$21.7 billion compared to \$13.5 billion). The income received by U.S. persons on their portfolio and other non-direct investments in Canada (\$23.6 billion in 2007), was 78 percent greater than the income received by Canadian persons from portfolio (non-governmental) and other non-direct investments in the United States (\$13.2 billion in 2007). Figure 3 records the cross-border income flows from direct and portfolio and other non-direct investments between the United States and Canada.

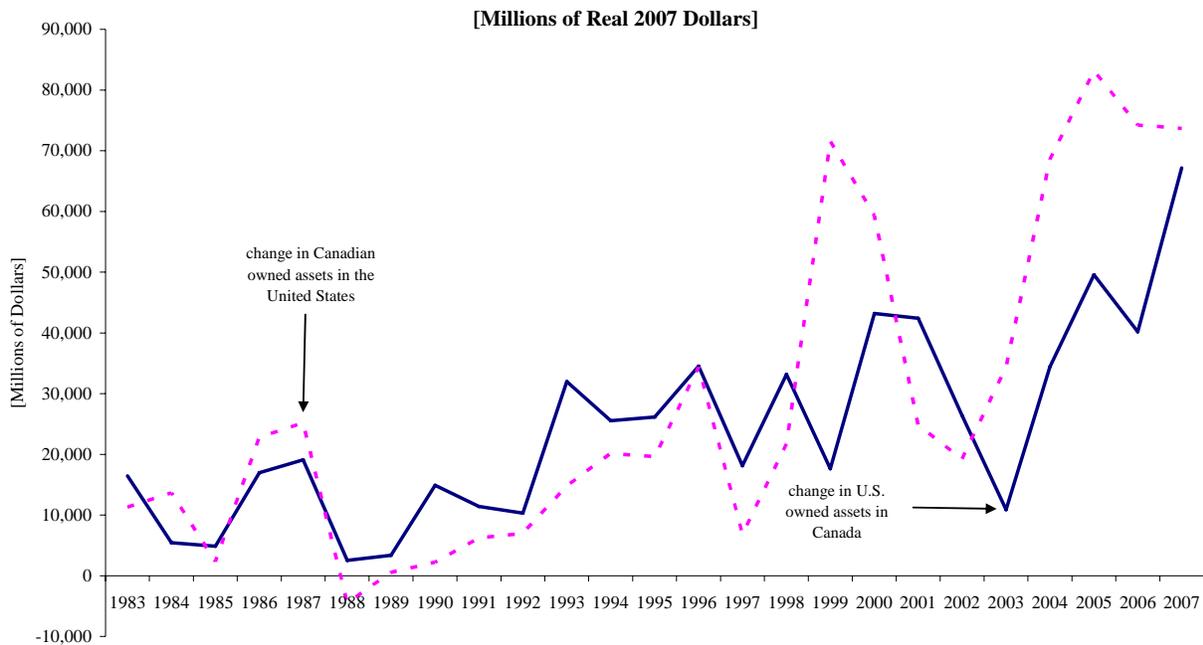
Figure 3.—U.S. and Canadian Income from Direct and Non-Direct Investments, 1983-2007
 [Millions of Real 2007 Dollars]



D. Trends in the Financial Account Between the United States and Canada

As discussed above, the current account of international transactions between the United States and Canada records the current-year flow of receipts from current export of goods and services and the income flows arising from past investments. The financial account of international transactions between the United States and Canada (the bottom portion of Table 1) measures the change in U.S. ownership of Canadian assets and the change in Canadian ownership of U.S. assets. The importance of the financial account, as documented in preceding discussion, is that ownership of assets abroad generates future receipts of income. In 2007, aggregate cross-border investment between the United States and Canada totaled \$140 billion. As Table 1 documented, in 2007, U.S. persons increased asset holding in Canada by \$67.2 billion while Canadian persons increased their ownership of U.S. assets by \$73.7 billion. Figure 4, below, shows the annual change in U.S.-owned Canadian assets and the annual change in Canadian-owned U.S. assets.⁵⁵

**Figure 4.—U.S. and Canadian Financial Account Carriage Return
Annual Change in Assets Owned,
1983-2007**



⁵⁵ In Figure 4 through Figure 6 a solid line indicates the net acquisition (purchase of assets, purchase of securities, bank deposit, or extension of credit) by U.S. persons of assets in Canada, and a broken line indicates the net acquisition by Canadian persons of U.S. assets. If any line reports a negative number, there was a net disposition of such assets.

Figure 5 and Figure 6 report the two largest components of these annual changes in asset ownership: direct investment and portfolio acquisition of securities (one component of non-direct investment). Figure 5 reports the annual change in U.S. direct investment in Canada and the annual change in Canadian direct investment in the United States since 1983. Almost all years since 1983 have showed an increase in the amount of direct investment in assets of the one country by investors in the other country. The changes measured in direct investment occur because of increases or decreases in equity investment, changes in intra-company debt, the reinvestment of earnings, and currency valuation adjustments.

Figure 5.—Change in U.S. and Canadian Direct Investment, 1983-2007
 [Millions of Real 2007 Dollars]

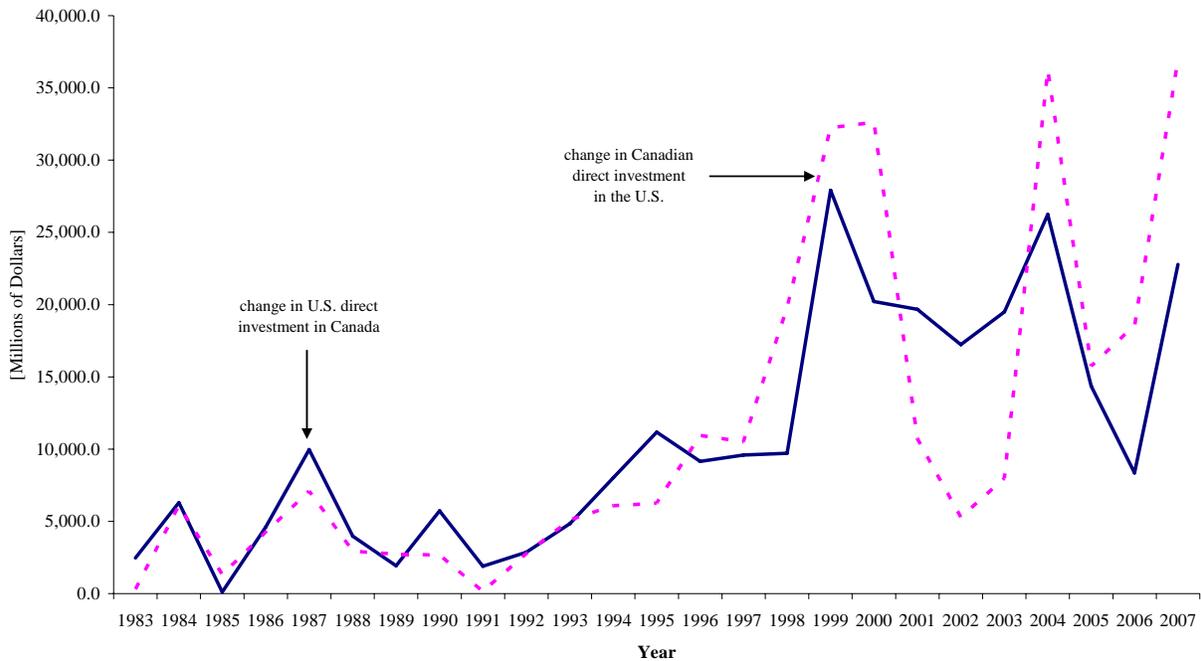
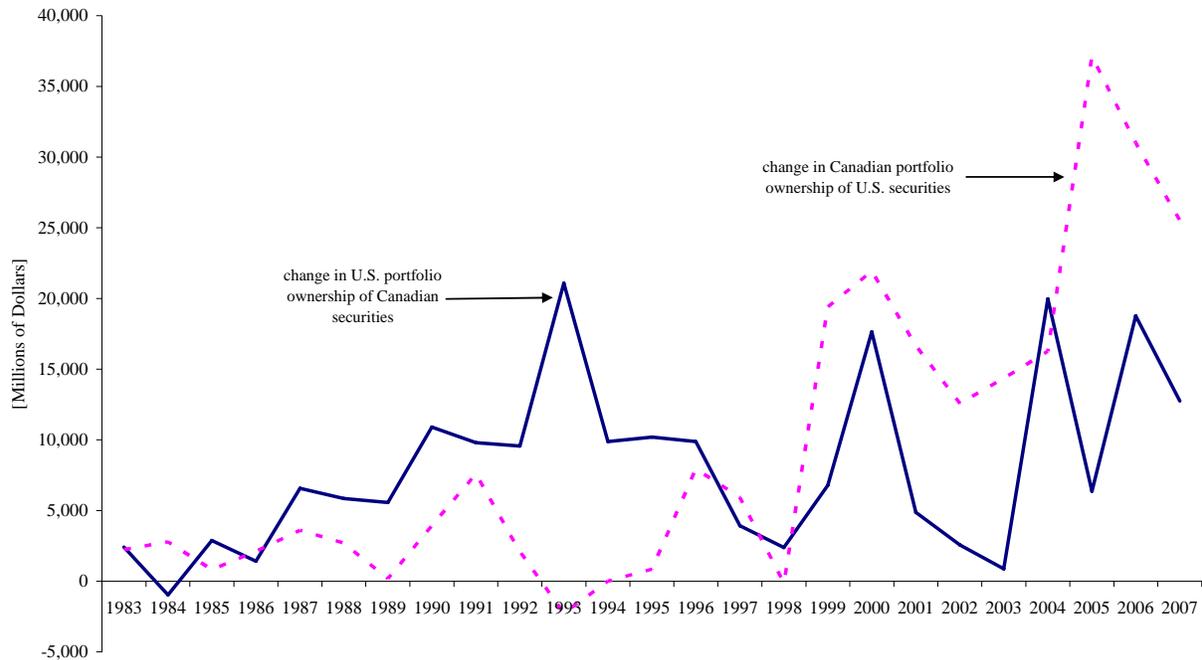


Figure 6.—Change in U.S. and Canadian Ownership of Portfolio Securities, 1983-2007
 [Millions of Real 2007 Dollars]



Total direct investment by U.S. persons in Canada is large. Measured on an historical cost basis,⁵⁶ the value of U.S. direct investment in Canada as of the end of 2006 was \$246.5 billion. This comprised 10.3 percent of total U.S. direct investment overseas and represented the second largest U.S. direct investment position in 2006 only exceeded by the United Kingdom (\$364.1 billion).⁵⁷ The value of Canadian direct investment in the United States at the end of 2006 was \$159 billion. This comprised 8.9 percent of total foreign direct investment in the United States and represented the fifth largest foreign direct investment position in the United States after the United Kingdom, Japan, Germany, and the Netherlands.⁵⁸

Non-direct investment generally may be thought of as consisting of two components, portfolio investment, that is, the purchase of securities, and lending activities. Figure 6 reports the annual change in the holdings of Canadian securities (stocks and bonds) by U.S. persons and

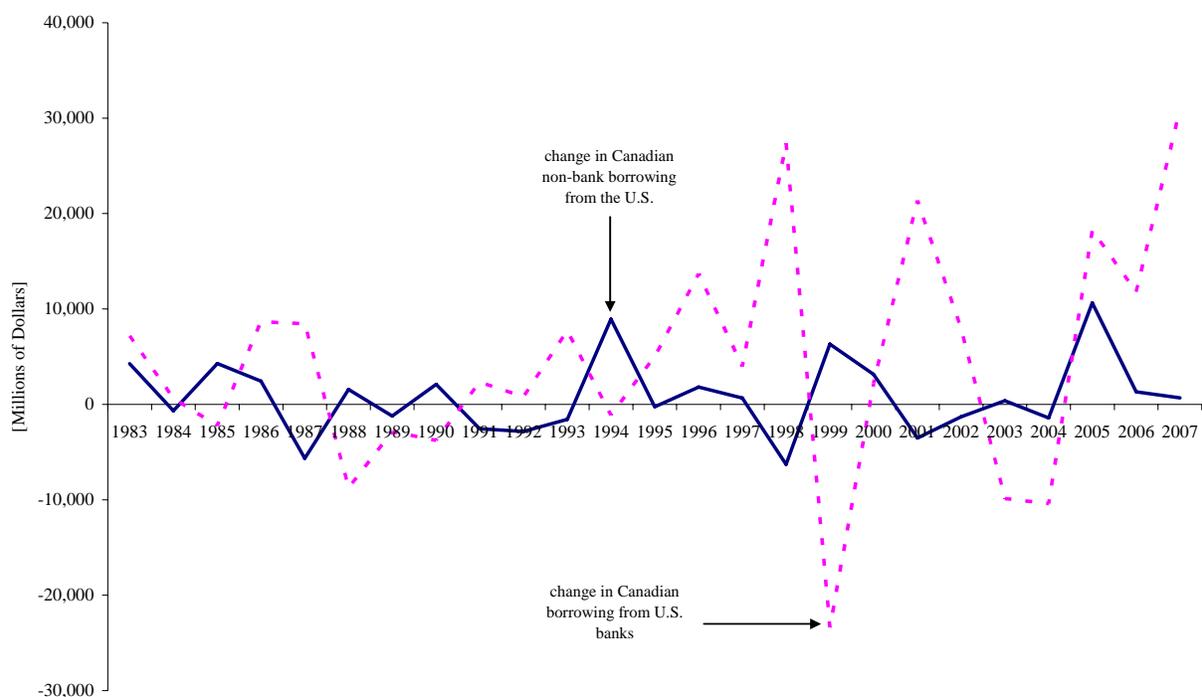
⁵⁶ The Bureau of Economic Analysis prepares detailed estimates of direct investment by country and industry on an historical cost basis only. Thus, the estimates reported reflect price levels of earlier periods. For estimates of aggregate direct investment the Bureau of Economic Analysis also produces current-cost and market value estimates.

⁵⁷ Marilyn Ibarra and Jennifer L. Koncz, “Direct Investment Positions for 2006: Country and Industry Detail,” vol. 87, *Survey of Current Business*, July 2007.

⁵⁸ *Ibid.*

the annual change in the holdings of U.S. securities (other than Treasury securities) by Canadian persons. In 2006, U.S. holdings of Canadian stocks and bonds had a year-end estimated value of \$479.9 billion.⁵⁹ Of this total, Canadian stocks account for \$310.9 billion and Canadian bonds account for \$169.0 billion.⁶⁰ Among U.S. holdings of foreign stocks, the value of Canadian stock held is third after holdings of U.K. equities and Japanese equities by U.S. persons.⁶¹ Canadian holdings of U.S. securities (other than Treasury securities) totaled \$311.0 billion of U.S. corporate stocks and \$83.2 billion of U.S. corporate bonds and the bonds of certain Federal agencies (other than general obligation Treasury bonds) at the end of 2006. In the case of equities, these holdings comprised 12.3 percent of total foreign holdings of U.S. equities. In the case of bonds, these holdings comprised 3.1 percent of total foreign holdings of such bonds.⁶²

Figure 7.—Change in U.S. Bank and Non-Bank Lending to Canadian Persons
[Millions of Real 2007 Dollars]



⁵⁹ Elena L. Nguyen, “The International Investment Position of the United States at Year end 2006,” *Survey of Current Business*, vol. 87, July 2007.

⁶⁰ *Ibid.*

⁶¹ *Ibid.* Among U.S. holdings of foreign bonds, U.S. holdings of Canadian bonds are second in size only to holdings of British bonds.

⁶² *Ibid.*

Lending activities, aside from the sale of debt securities, constitute the remaining source of non-direct cross-border investment. When a U.S. bank makes a loan to a foreign person abroad (including a foreign subsidiary), the U.S. bank is making a foreign investment. Non-bank U.S. persons also make foreign investments through lending activities. When a non-bank U.S. person makes a deposit in a foreign bank, the non-bank U.S. person is making a foreign investment. Likewise if a U.S. business draws on a line of credit from a bank in Canada, the Canadian bank is making an investment in the United States. Such deposit and borrowing activity can be quite variable and changes in exchange rates and business activity abroad may lead to substantial variability in the annual level of such activity. Figure 7 reports the changes in lending by U.S. banks and non-banking U.S. persons to Canadian persons since 1983. There are not comparable publicly available data for similar borrowings by U.S. persons from Canadian banks and non-banking Canadian persons.

E. Income Taxes and Withholding Taxes on Cross-Border Income Flows

The data presented above report the amount of direct investment in Canada by U.S. persons and the amount of direct investment in the United States by Canadian persons. Data from tax returns reflect the magnitudes of cross-border investment and trade and income flows reported above. In 2003, U.S. corporations with Canadian parent companies had \$4.0 billion of income subject to tax and paid \$1.3 billion in U.S. Federal income taxes.⁶³ U.S. corporations, including U.S. parent companies of Canadian controlled foreign corporations, reported the receipt of \$15.6 billion of dividends from Canadian corporations in 2003.⁶⁴ Of the \$15.6 billion in dividends reported, approximately \$5.1 billion reflected the grossed up value of net dividends to account for deemed taxes paid to Canada. U.S. corporations recognized about \$22.1 billion in taxable income originating in Canada, including the dividend amounts just cited. This income was subject to an average Canadian corporate income tax rate of approximately 28.6 percent (after allowing for apportionment and allocation of certain expenses incurred in the United States).

⁶³ James R. Hobbs, "Foreign Controlled Domestic Corporations, 2003," *Statistics of Income Bulletin*, vol. 86, Summer 2006, pp. 67-112.

⁶⁴ Robert Singmaster, "Corporate Foreign Tax Credit, 2003," *Statistics of Income Bulletin*, vol. 87, Fall 2007, pp. 225-78.

F. Analyzing the Economic Effects of Income Tax Treaties

Among other things, tax treaties often change both the amount and timing of income taxes and the country (source or residence) that has priority to impose such taxes. If the tax treaty changes increase the after-tax return to cross-border trade and investment, or to particular forms of trade or investment, in the long run there could be significant economic effects. Generally, to the extent a treaty reduces barriers to capital and labor mobility, more efficient use of resources will result and economic growth in both countries will be enhanced, although there may be negative transitional effects occurring in specific industries or geographic regions. On the other hand, tax treaties may also lead to tax base erosion if they create new opportunities for tax arbitrage. Tax treaties also often increase and improve information sharing between tax authorities. Improvements in information sharing and the limitation of benefits provision should reduce the potential for outright evasion of U.S. and Canadian income tax liabilities.

Generally, a treaty-based reduction in withholding rates will directly reduce U.S. tax collections in the near term on payments from the United States to foreign persons, but will increase U.S. tax collections on payments from foreign persons to the United States because of the reduction in foreign taxes that are potentially creditable against the U.S. income tax. To the extent that the withholding rate reduction encourages more income flows between the treaty parties, this dampening of collections on payments to foreign persons and related decrease in foreign tax credits will begin to reverse. The present protocol's modifications of payments that qualify as dividends for reductions in dividend withholding rates that are already part of the present treaty will maintain reduced U.S. withholding tax collections on dividend payments from the United States to Canada. The present protocol's reduction in withholding rates on interest income will reduce U.S. withholding tax collections on interest payments from the United States to Canada. Over the longer term, the reduced withholding tax rates of the present treaty coupled with other changes in the protocol are likely to cause small revenue increases in later years as capital flows increase and from improved allocation of capital.

However, this simple analysis is incomplete. A complete analysis of withholding taxes, or any other change in a treaty, would account for both tax and non-tax related factors, such as portfolio capital needs in the affected countries, and the corresponding relation between current and financial accounts. The potential for future growth in each country is an important determinant of cross-border investment decisions. In sum, even in the short run, the larger macroeconomic outlook, compared to treaty modifications, is likely to be a more important determinant of future cross-border income and investment flows and the related tax collections.

V. EXPLANATION OF PROPOSED PROTOCOL

Article 1. General Definitions

Article III (General Definitions) of the treaty provides definitions of a number of terms for purposes of the treaty. The proposed protocol adds a definition for the term “national” of a treaty country. It defines a national of a treaty country as (1) any individual possessing the citizenship or nationality of the contracting state, and (2) any legal person, partnership, or association deriving its status as such from the laws in force in that treaty country. The definition is the same as that in the U.S. Model treaty. The term national is relevant for paragraph (1) of Article XXVI (Mutual Agreement Procedure) of the treaty and, as amended by the proposed protocol, paragraph (1) of Article XXV (Non-Discrimination) of the treaty.

Article III also provides rules for determining the meaning of terms not defined in the treaty. It provides that when a treaty country applies the treaty, any term not defined in the treaty has the meaning it has under the laws of that country concerning the taxes covered by the treaty, unless the context otherwise requires or the competent authorities otherwise agree. The General Note clarifies that the tax laws of a treaty country prevail over non-tax laws of the treaty country for purposes of determining the meaning of an undefined term. This clarification conforms to the U.S. Model treaty.

Article 2. Residence

In general

Article 2 of the proposed protocol makes two significant changes to Article IV (Residence) of the treaty. Paragraph 1 of Article 2 of the proposed protocol replaces paragraph 3 of Article IV of the treaty to address the treatment of so-called dual resident companies. Paragraph 2 of Article 2 of the proposed protocol adds new paragraphs 6 and 7 to Article IV. These paragraphs address whether income is considered to be derived by a resident of a treaty country in cases in which such income is derived through, or received from, a fiscally transparent entity.

Dual resident companies

Prior and present treaty rules

In general, under prior and present versions of paragraph 1 of Article IV of the treaty, a company is a resident of a treaty country if, under the laws of that country, the company is liable to tax therein by reason of its domicile, residence, place of management, place of incorporation or any other criterion of a similar nature. Paragraph 3 of Article IV of the treaty, as originally signed in September 1980, provided that a company that is a resident of both treaty countries by reason of that general rule is deemed to be a resident of the treaty country under whose laws it was created. The technical explanation to the original version of the treaty stated that the provision was “making clear that the tie-breaker rule for a company is controlled by the country of the company’s original creation. Various jurisdictions may allow local incorporation of an entity that is already organized and incorporated under the laws of another country. Paragraph 3

provides certainty in both the United States and Canada with respect to the treatment of such an entity for purposes of the Convention.”

The Protocol dated March 17, 1995 added a special rule at the end of paragraph 3 which states that “[n]otwithstanding the preceding sentence, a company that was created in a Contracting State, that is a resident of both Contracting States and that is continued at any time in the other Contracting State in accordance with the corporate law in that other State shall be deemed while it is so continued to be a resident of that other State.” The technical explanation to that Protocol states that “[c]ertain jurisdictions allow local incorporation of an entity that is already organized and incorporated under the laws of another country. Under Canadian law, such an entity is referred to as having been “continued” into the other country. Although the Protocol uses the Canadian term, the provision operates reciprocally. The new sentence states that such a corporation will be considered a resident of the State into which it is continued.” Thus, in the case of a continued company, the 1995 protocol adopted a tie-breaker rule that is the opposite of the rule in the treaty as originally ratified.

On September 18, 2000, both the United States and Canada issued press releases that stated the two countries intended to clarify the residence rule in the case of continuance, and that the clarification would be incorporated into the treaty and relate back to the date of the press release.⁶⁵ As noted in the 1995 technical explanation, a continuance occurs when a company incorporated in one jurisdiction “continues” into another jurisdiction. In that case, it is generally treated for corporate law purposes as though it had been incorporated there. The press releases state that some U.S. companies that had continued into Canada had asserted that they were U.S. corporations for purposes of U.S. internal tax law, but were also Canadian residents under the U.S.-Canada tax treaty. The press releases also state that the tax authorities did not contemplate that the continuance provision of the 1995 protocol would be used in that manner. The press releases further state that that the revised treaty rule would clarify that a company incorporated in one country that continues into the other will still be treated as a resident of the first country unless that country’s internal law no longer treats it as such. Such a dual resident company will not be entitled to any benefits under the U.S.-Canada treaty except to the extent agreed upon by the competent authorities.

On January 30, 2006, the Department of the Treasury and the IRS finalized regulations which, in relevant part, provide that, for U.S. domestic tax law purposes, a business entity (including an entity that is disregarded as separate from its owner) is domestic if it is created or organized as any type of entity in the United States, or under the law of the United States or of any State, even if it is also created or organized in a foreign jurisdiction.⁶⁶ Thus, under U.S. domestic law, both (1) foreign corporations that continue into the United States, and (2) corporations incorporated under State law that continue into a foreign country but retain their State incorporation status are treated as domestic corporations.

⁶⁵ Press Release LS-883, U.S. Department of the Treasury (Sept. 18, 2000); Press Release 2000-068, Canada Department of Finance (Sept. 18, 2000).

⁶⁶ Treas. Reg. sec. 301.7701-5(a).

Paragraph 3 under proposed protocol

The proposed protocol replaces paragraph 3. The provisions of new paragraph 3 and its effective date are consistent with the intent of the treaty countries to clarify the treaty effects of a corporate continuance, as expressed in the press releases issued on September 18, 2000. New paragraph 3 (as present paragraph 3), applies only where a company is a resident of both treaty countries by reason of the general rules set forth in paragraph 1.

Under new subparagraph 3(a), if the dual resident company is created under the laws in force in a treaty country but not under the laws in force in the other treaty country, the company is deemed to be a resident only of the first treaty country. The Department of the Treasury Technical Explanation of the Protocol Done at Chelsea on September 21, 2007 Amending the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital Done at Washington on September 26, 1980, as Amended by the Protocols done on June 14, 1983, March 28, 1994, March 17, 1995, and July 29, 1997 (the "Technical Explanation") provides an example under which a company is incorporated in the United States but the company is also otherwise considered a resident of Canada under Canadian domestic tax law because the company is managed in Canada. Under subparagraph 3(a), such a company is considered a resident only of the United States for purposes of the treaty. Subparagraph 3(a) would also apply where a corporation incorporated in the United States continues into Canada and then cancels its U.S. corporate charter. This rule is consistent with the general rule of the present and prior versions of paragraph 3.

Subparagraph 3(b) provides that in any case to which the provisions of subparagraph 3(a) do not apply, the competent authorities of the treaty countries must endeavor to settle the question of residency by mutual agreement and determine the mode of application of the treaty to the company. Subparagraph 3(b) also provides that in the absence of such agreement, the company is not considered to be a resident of either treaty country for purposes of claiming any benefits under the treaty.

As noted in the press releases described above, Subparagraph 3(b) is intended to address corporate continuance transactions in which a company is deemed to be organized, created, or incorporated in both treaty countries under their respective corporate laws. Paragraph 3, by its terms, operates reciprocally. According to the Technical Explanation, subparagraph 3(b) applies to continuance transactions occurring between the treaty countries if the corporation retains its charter in the first country, and also addresses so-called serial continuance transactions in which a company continues from one of the treaty countries to a third country and then continues into the other treaty country without having ceased to be treated as resident in the first treaty country.

Paragraph 3(a) of Article 27 of the proposed protocol provides that new paragraph 3 is effective with respect to corporate continuances after September 17, 2000.

Fiscally transparent entities

In general

Paragraph 2 of Article 2 of the proposed protocol adds paragraphs 6 and 7 to Article IV of the treaty. These new paragraphs provide specific rules for the treatment of amounts of

income, profit, or gain derived through or paid by fiscally transparent entities. As explained more fully below, fiscally transparent entities are entities the income of which is taxed at the beneficiary, member, or participant level. Entities that are subject to tax, but with respect to which tax may be relieved under an integrated system, are not considered fiscally transparent entities. Entities that are fiscally transparent for U.S. tax purposes include partnerships, common investment trusts under section 584, grantor trusts, and business entities such as a limited liability company (“LLC”) that is treated as a partnership or is disregarded as an entity separate from its owner for U.S. tax purposes, including those entities that may elect such status.⁶⁷ According to the Technical Explanation, entities falling within this description in Canada are (except to the extent the law provides otherwise) partnerships and what are known as “bare” trusts. These new paragraphs are relevant to a number of articles of the treaty, including Article V (Permanent Establishment), Article VII (Business Profits),⁶⁸ Article X (Dividends), Article XI (Interest), and Article XII (Royalties).

The Code and regulations also address some of the issues arising under these proposed treaty provisions. Section 894(c)(1) provides that a foreign person is entitled to a reduced rate of withholding tax under a treaty with a foreign country on an item of income derived through an entity that is treated under U.S. tax rules as a partnership or otherwise fiscally transparent only if such item is treated for purposes of the foreign country’s tax laws as an item of income of the foreign person. However, that rule does not apply if the treaty itself contains a provision addressing the applicability of the treaty in the case of income derived through a partnership, or if the foreign country generally imposes tax on an actual distribution of such item of income from such entity to such person. Section 894(c)(2) requires the Secretary to prescribe regulations to address similar cases not covered under section 894(c)(1).⁶⁹

The enactment of section 894(c)(1) was intended to address certain tax avoidance structures in which a Canadian corporation would organize a U.S. subsidiary that was fiscally transparent under U.S., but not Canadian law. U.S.-source interest paid to the U.S. subsidiary by another, fiscally nontransparent, U.S. subsidiary would be deductible for U.S. tax purposes by the second U.S. subsidiary, but would be excluded from income of both the first U.S. subsidiary and the Canadian parent company for U.S. and Canadian tax purposes, respectively. In addition, the payment would be subject to a reduced rate of withholding under the treaty prior to enactment of section 894(c), and a distribution from the fiscally transparent U.S. subsidiary to the Canadian parent would not be subject to Canadian tax pursuant to a dividend exclusion under domestic Canadian law.

⁶⁷ Treas. Reg. secs. 301.7701-2 and -3 classify certain of these entities as fiscally transparent and permit such elections.

⁶⁸ Thus, as noted in the Technical Explanation, the proposed protocol is broader in scope than section 894(c), which addresses withholding taxes but not business profits or income effectively connected with the conduct of a trade or business in the United States.

⁶⁹ Section 894(c) was enacted by Pub. L. No. 105-34, sec. 1054 (1997) (Taxpayer Relief Act of 1997). See H.R. Rep. No. 105-220, at 572-75 (1997 (Conference Report)). The legislative history of section 894(c) reflects that Congress anticipated the negotiation of these treaty provisions.

The regulations promulgated under section 894 provide, in part, that for purposes of U.S. income tax treaties, an entity is, in general, fiscally transparent under the laws of an interest holder's jurisdiction (i.e., where the interest holder is resident) with respect to an item of income to the extent that the laws of that jurisdiction require the interest holder resident in that jurisdiction to separately take into account on a current basis the interest holder's respective share of the item of income paid to the entity, whether or not distributed to the interest holder, and the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity.⁷⁰

The treatment of amounts of income, profit, and gain derived through certain entities under paragraphs 6 and 7 also depend in part on whether or not these amounts are treated the same in the interest holder's jurisdiction as they would be if those amounts had been derived directly by the interest holder. The Technical Explanation states that this determination is to be made in accordance with the principles of section 894 and the regulations under that section. The Technical Explanation adds that, although Canada does not have analogous provisions in its domestic law, it is anticipated that Canada will apply principles comparable to those described above.

The rules of paragraphs 6 and 7 are generally consistent with those of the U.S. Model treaty, which provides in Article 1, paragraph 6 that "[a]n item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident." The Technical Explanation to the U.S. Model treaty states that the two goals of that provision are (1) to eliminate technical problems that would have prevented investors using such entities from claiming treaty benefits, and (2) to prevent the use of such entities to claim treaty benefits where the investors are not subject to tax on the income in their state of residence.

Paragraph 6

Paragraph 6 sets forth the "positive" rule of derived income that an amount of income, profit, or gain is considered to be derived by a resident of a treaty country if (1) that person is considered under the taxation law of that country to have derived the amount through an entity, other than an entity that is a resident of the other treaty country, and (2) by reason of that entity being treated as fiscally transparent under the laws of the first treaty country, the treatment of the amount under the taxation law of that country is the same as its treatment would be if that amount had been derived directly by that person.

For example, if a U.S. resident owns a non-Canadian entity (including a U.S. entity) that earns Canadian-source interest and the entity is considered fiscally transparent under U.S. tax law, the U.S. resident is considered under the tax law of the United States to have derived the interest through the entity and, because the entity is treated as fiscally transparent under U.S. tax law, the treatment of the income under the U.S. tax law is the same as its treatment would be if

⁷⁰ Treas. Reg. sec. 1.894-1(d)(3)(iii).

that amount had been derived directly by the U.S. resident. Thus, the U.S. resident is considered to derive the Canadian-source interest under paragraph 6. This would be the case even if Canada does not view the entity as fiscally transparent under its tax laws.

Similarly, if a Canadian resident derives U.S.-source income, profit, or gain through a non-U.S. entity that is considered a partnership for Canadian tax purposes, such U.S.-source income, profit, or gain will be considered to be derived by the Canadian resident under paragraph 6, even if the entity is considered to be a corporation for U.S. tax purposes.

The Technical Explanation discusses how Canada and the United States will apply the rules of paragraph 6. The Technical Explanation states that in determining the entitlement of a resident of the United States to the benefits of the treaty, Canada will apply the Convention within its own legal framework. However, this general rule appears to apply to the United States as well. Paragraph 6 is to be applied with due regard to the general tax rules of the United States or Canada, as applicable.

In this regard, it is important to recognize that, under the treaty, a fiscally transparent entity is generally not a resident of the country in which it is organized because it is not taxable there. Thus, Canada would neither consider a U.S. LLC that is fiscally transparent for U.S. tax purposes (“USLLC”) to be a U.S. resident, nor treat USLLC as if it did not exist, notwithstanding that Canada would extend treaty benefits under paragraph 6 to the U.S. owners of USLLC.⁷¹

If the income in question under the treaty is business profits, it will be necessary to determine whether the income was earned through a permanent establishment in Canada. Under Canadian law, this determination will be based on the presence and activities in Canada of USLLC itself, not of its shareholders acting in their own right. Assuming that USLLC is carrying on business in Canada, but does not do so through a permanent establishment there, only that portion of its profits that belongs to the U.S. resident shareholder will be entitled to benefits under Article VII (Business Profits), provided that the U.S. resident meets the requirements of Article XXIX A (Limitation on Benefits). The balance of the LLC’s profits will remain taxable in Canada. On the other hand, if USLLC does have a permanent establishment in Canada, although the U.S. resident owners are treated as having derived the business profits under the treaty, Canada will subject the LLC, and not the owners, to liability on the business profits attributable to the permanent establishment under Article VII.

According to the Technical Explanation, in the inverse situation, that is, where an entity is considered fiscally transparent for Canadian tax purposes but is not considered fiscally transparent for U.S. tax purposes, the United States looks to both the activities of the entity and the activities of its partners (or members) in determining whether that entity has a permanent

⁷¹ This treatment has certain administrative implications. According to the Technical Explanation, Canada would not require the shareholders of such an LLC to file Canadian tax returns in respect of income that benefits from new paragraph 6. Instead, the LLC itself must file a Canadian tax return in which it claims the benefits of the paragraph and supply any documentation required to support the claim.

establishment in the United States. If the determination is that the entity carries on the business through a permanent establishment, that permanent establishment may be attributed to the partners. On the other hand, if it is determined that the entity does not carry on the business through a permanent establishment, the partners who are Canadian residents and who derive income through the partnership may claim the benefits of Article VII of the treaty with respect to such income if they meet the requirements of Article XXIX A, assuming that the income is not otherwise attributable to a permanent establishment of the partner.

Paragraph 7

Paragraph 7 sets forth two “negative” rules of derived income, in which an item of income, profit, or gain is considered not to be paid to or derived by a person who is a resident of a treaty country. Under subparagraph 7(a), an amount of income, profit, or gain is considered not to be paid to or derived by a person who is a resident of a treaty country if (1) that person is considered under the taxation law of the other treaty country as deriving the amount through an entity that is not a resident of the first treaty country, but (2) by reason of the entity not being treated as fiscally transparent under the laws of that treaty country, the treatment of the amount under the taxation law of that country is not the same as its treatment would be if that amount had been derived directly by the person.

From the U.S. point of view, the rule of subparagraph 7(a) addresses the same circumstances as section 894(c)(1) described above. From the Canadian perspective, subparagraph 7(a) would apply in the case of U.S. residents owning a Canadian (or third-country) entity that is fiscally transparent for Canadian tax purposes but not for U.S. tax purposes and receives Canadian source income.

Subparagraph 7(b) addresses whether the recipient of a payment that is made from a fiscally transparent entity to its owner is entitled to treaty benefits with respect to that payment. It provides that an amount of income, profit, or gain is not considered to be paid to or derived by a person who is a resident of a treaty country if: (1) the person is considered under the tax law of the other treaty country to have received the amount from an entity resident in the other treaty country, but (2) by reason of the entity being treated as fiscally transparent under the laws of the first treaty country, the treatment of the amount received by that person under the tax law of that country is not the same as its treatment would be if the entity were treated as not fiscally transparent under the laws of that country.

The two basic fact patterns encompassed by subparagraph 7(b) may be illustrated by two examples. For the first example, assume that a company resident in the United States is the sole owner of a Nova Scotia unlimited liability company (“NSULC”), an entity that is considered under Canadian tax law to be a corporation that is resident in Canada but is considered under U.S. tax law to be disregarded as an entity separate from its owner.⁷² Under subparagraph 7(b), a payment from such an NSULC to its sole owner is not considered to be paid to or derived by the owner. Under U.S. tax law, such payments are considered to be nonexistent. Therefore, the

⁷² In the absence of an election to the contrary, such an entity is disregarded as an entity separate from a sole owner. Treas. Reg. secs. 301.7701-2(b)(8)(ii)(A)(1) and 301.7701-3(b)(2)(C).

owner is ineligible for treaty benefits with respect to such payments, and Canada will not reduce its rates of withholding pursuant to the treaty.⁷³

The second example, provided by the Technical Explanation, relates to partnership distributions. In the example, CanCo is a Canadian entity that is a corporate resident of Canada under Canadian tax law, but which for U.S. tax purposes is a partnership. A U.S. company is one of the owners of CanCo and is, therefore, a shareholder of CanCo for Canadian tax purposes but a partner of CanCo for U.S. tax purposes. In the example, CanCo makes a payment to its U.S. owner that is treated as a dividend for Canadian tax purposes but which is viewed as a partnership distribution for U.S. tax purposes. The Technical Explanation provides that subparagraph 7(b) applies to preclude treaty benefits with respect to the payment because the U.S. tax treatment of the payment (as a partnership distribution) is different than it would be if CanCo were treated as a corporation for U.S. tax purposes (as a dividend).

The provisions of subparagraph 7(b) have been questioned by certain commentators and raise certain issues. These issues and a more extensive discussion of the examples in the Technical Explanation are discussed in the Issues section of this document.

Effect on S corporations

The Technical Explanation also addresses the status of S corporations under these rules. A corporation that has elected under section 1362 to be taxed under Subchapter S of Chapter 1 of the Code (an “S corporation”) is treated as fiscally transparent by the United States. Thus, a U.S. resident shareholder of an S corporation is considered under paragraph 6 to derive income from Canada earned through the S corporation. According to the Technical Explanation, Canada will ordinarily accept that an S corporation is itself resident in the United States for purposes of the treaty. Therefore, Canada will generally allow treaty benefits to the S corporation in its own right. Because Canada does not view S corporations as fiscally transparent, however, a Canadian resident who is a shareholder of an S corporation that has U.S.-source income, profits, or gains is not considered as deriving the income by virtue of subparagraph 7(a).

Fiscal transparency and beneficial ownership

The Technical Explanation discusses the interaction of the rules of paragraph 6 and 7 with the determination of the beneficial owner under the treaty. In general, the term “beneficial owner” refers to the person to which the income is attributable under the laws of the source country.⁷⁴ A nominee or agent receiving an item of income on behalf of another person is generally not considered to be the beneficial owner of that item. For example, a dividend from a source in a treaty country received by a nominee that is a resident of the other treaty country on

⁷³ Thus, Canada will apply its statutory withholding rate of 25 percent on such payments of dividends, interest, rents, and royalties.

⁷⁴ Because the term “beneficial owner” is not specifically defined under the treaty, it has the meaning which it has under the law of the treaty country imposing the relevant tax, i.e., the source country, pursuant to Article III, paragraph 2 of the treaty.

behalf of a person that is not a resident of that other country is not entitled to the benefits of the treaty, while a dividend received by a nominee on behalf of a resident of that other country would be entitled to such benefits.

The Technical Explanation provides that in the case of income, profits, or gains derived through a fiscally transparent entity, as described above, the tax laws of the residence country are to be applied first to determine whether an owner of the entity derives the income, profits, or gains. Source country principles of beneficial ownership are then applied to determine whether the person who has been determined to derive the income, profits, or gains (or some other person) is the beneficial owner of the income, profits, or gains.

Article 3. Permanent Establishment

In general

The proposed protocol adds a special rule for services in paragraph 9 of Article V (Permanent Establishment) of the treaty, under which services performed by an enterprise of a treaty country in the other treaty country may give rise to a permanent establishment in the other country.⁷⁵ If paragraph 9 applies, the services are taxed on a net basis under Article VII (Business Profits) of the treaty as modified by the proposed protocol, and such taxation, therefore, is limited to the profits attributable to the activities carried on in performing those services. According to the Technical Explanation, paragraph 9 applies only to services provided by the enterprise to third parties, and not to services provided to that enterprise (i.e., intercompany services). Neither the U.S. Model treaty nor the OECD Model treaty provides a similar rule for services, although the OECD has issued a draft update to its Model that includes an amendment to the commentary with an example of an alternative permanent establishment provision that is generally similar to paragraph 9, as further described in the Issues section of this document.

Under paragraph 9, subject to paragraph 3 of Article V of the treaty, an enterprise of a treaty country that provides services in the other treaty country, but which does not have a permanent establishment there by virtue of the other provisions of Article V, is deemed to provide those services through a permanent establishment in the other treaty country if and only if the enterprise meets one of two tests.

Single individual test

The first test (subparagraph 9(a)) is generally aimed at enterprises that earn most of their income through the personal services of a small number of individuals. The test is employed to determine whether an enterprise of one treaty country is deemed to have a permanent establishment by virtue of the presence of a single individual in the other treaty country. Under subparagraph 9(a), a permanent establishment is deemed to exist if (1) the services are performed

⁷⁵ The proposed protocol replaces paragraph 9 of Article V of the present treaty and reinserts the identical language as paragraph 10. New paragraph 10 provides that the provisions of Article V shall be applied in determining whether any person has a permanent establishment in any country.

in the other treaty country by an individual who is present in the other treaty country for a period or periods aggregating 183 days or more in any 12-month period, and (2) during that period or periods, more than 50 percent of the gross active business revenues of the enterprise consists of income derived from the services performed in the other treaty country by that individual. Both (1) and (2) must be met in order to meet the test of subparagraph 9(a).

According to the Technical Explanation, for purposes of subparagraph 9(a), the term “gross active business revenues” means the gross revenues attributable to active business activities of the enterprise that has been (or should be) charged to its customers, regardless of when the actual billing occurs and of domestic tax law rules concerning when such revenues should be taken into account. Under the test of subparagraph 9(a), such active business activities are not restricted to the activities related to the provision of services (but the term does not include income from passive investment activities).

Enterprise test

Under the second test (subparagraph 9(b)), a permanent establishment is deemed to exist if an enterprise of a treaty country (1) provides services in the other treaty country for an aggregate of 183 days or more in any 12-month period with respect to the same or connected projects, and (2) such services are provided for customers who are either residents of the other treaty country, or maintain a permanent establishment in the other treaty country and the services are provided to such permanent establishment. According to the Technical Explanation, requirement (2) enforces the principle that unless the taxpayer is providing services in the other country to a customer that is either a resident or has a permanent establishment there, such enterprise will not be participating sufficiently in the economic life of that other country to warrant taxation. Both (1) and (2) must be met in order to meet the test of subparagraph 9(b).

Subparagraph 9(b) requires that the services be provided “with respect to the same or connected projects.” Paragraph 2 of the General Note provides that for purposes of subparagraph 9(b), projects shall be considered to be connected if they constitute a coherent whole, commercially and geographically. These “aggregation rules” are intended, in part, to address potentially abusive situations in which work has been artificially divided into separate components in order to avoid meeting the 183-day threshold. The Technical Explanation states that the determination of whether projects are connected should be made from the point of view of the enterprise and not that of the customer, and depends on the facts and circumstances of each case.

According to the Technical Explanation, in determining the existence of “commercial coherence,” relevant factors (which are not by themselves determinative) include: (1) whether the projects would, in the absence of tax planning considerations, have been concluded pursuant to a single contract; (2) whether the nature of the work involved under different projects is the same; and (3) whether the same individuals are providing the services under the different projects.

In order to be considered connected, projects must also constitute a coherent whole geographically. The Technical Explanation provides an example of projects that lack geographic coherence in a case in which an enterprise is hired to execute separate auditing projects at

different branches of a bank located in different cities pursuant to a single contract. While the projects are commercially coherent, they are not geographically coherent. Thus, each separate auditing project would be considered separately for purposes of subparagraph 9(b).

Examples of single individual and enterprise tests

The Technical Explanation provides a few examples of how these provisions operate under certain facts. In one example, CanCo, a Canadian company, wishes to acquire USCo, a company in the United States. CanCo hires Canlaw, a Canadian law firm, to conduct a due diligence evaluation of USCo's legal and financial standing in the United States. Canlaw sends a staff attorney to the United States to perform the due diligence analysis of USCo. That attorney is present and working in the United States for greater than 183 days. If the remuneration paid to Canlaw for the attorney's services does not constitute more than 50 percent of Canlaw's gross active business revenues for the period during which the attorney is present in the United States, Canlaw will not be deemed to provide the services through a permanent establishment in the United States by virtue of subparagraph 9(a). In addition, because the services are being provided for a customer (CanCo) who neither is a resident of the United States nor maintains a permanent establishment in the United States to which the services are provided, Canlaw will also not have a permanent establishment in the United States by virtue of subparagraph 9(b).

Physical presence and day counting

Notwithstanding that subparagraph 9(a) refers to services that "are performed" in the other treaty country by an individual who "is present" in the other treaty country for 183 days or more in any twelve-month period, and subparagraph 9(b) refers to services that "are provided" in the other treaty country for 183 days or more in any twelve-month period, both subparagraphs are intended to apply only to services physically performed in the other treaty country. Thus, the Technical Explanation provides that customer support services provided cross border by telephone or computer would not be covered by paragraph 9, and days in which no individuals of the enterprise are physically in the other treaty country would not count for purposes of the 183-day threshold (for purposes of either subparagraph), even if individuals spend such days working on the project in the country of the enterprise.

The Technical Explanation, however, explains the significance of the differences in the language quoted in the immediately preceding paragraph. Subparagraph 9(a) refers to days in which an individual "is present" in the other country. Accordingly, physical presence of such individual during a day is sufficient, irrespective of whether the individual actually performs work on that day. Subparagraph 9(b), in contrast, refers to days during which services "are provided" by the enterprise in the other treaty country. Thus, days on which no services are actually provided in the other country (such as weekends or holidays in most cases) do not count for purposes of subparagraph 9(b). In addition, the Technical Explanation provides that, for purposes of both subparagraphs, the collective presence of more than one individual providing services during one calendar day will count for only one day of the enterprise's presence in the other treaty country.

Administrative issues

As more fully discussed in the Issues section of this document, the rules of paragraph 9 may give rise to certain administrative issues, including the potential for excess withholding or estimated tax payments with respect to employee wages that may result from the application of paragraph 9 and its interaction with Article XV (Income from Employment), as modified by the proposed protocol. The Technical Explanation states that the competent authorities are encouraged to consider adopting rules to address these potential issues.

Coordination with other provisions of Article V

As stated above, paragraph 9 is subject to the provisions of paragraph 3 of Article V of the treaty. Paragraph 3 provides that a building site or construction or installation project constitutes a permanent establishment if, but only if, it lasts more than twelve months. Thus, paragraph 9 does not apply to construction services that do not meet the requirements of paragraph 3 for a permanent establishment. On the other hand, paragraph 9 is not subject to the provisions of paragraph 4 of Article V of the treaty. Paragraph 4 provides that the use of an installation or drilling rig or ship in a treaty county to explore for or exploit natural resources constitutes a permanent establishment if, but only if, such use is for more than three months in any twelve-month period. Thus, drilling services that do not meet the requirements of paragraph 4 for a permanent establishment may still give rise to a deemed permanent establishment if the requirements of paragraph 9 are met.

In addition to adding paragraph 9, the proposed protocol amends paragraph 6 of Article V of the treaty to include a reference to paragraph 9. Paragraph 6 provides that certain preparatory or auxiliary activities conducted through a “fixed place of business” solely used for such activities do not give rise to a permanent establishment. Although paragraph 9 does not apply in the case of a “fixed place of business,” the Technical Explanation explains that paragraph 9 does not apply to deem any services to be provided through a permanent establishment if the services are limited to those mentioned in paragraph 6 which, if performed through a fixed place of business, would not make the fixed place of business a permanent establishment under the provisions of that paragraph. The Technical Explanation further explains that, because paragraph 6 of Article V applies notwithstanding paragraph 9, days spent on preparatory or auxiliary activities described in paragraph 6 are not taken into account for purposes of applying subparagraph 9(b).

Article 4. Business Profits

Internal taxation rules

United States

U.S. law distinguishes between the U.S. business income and the other U.S. 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 certain 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 income (from any source) that is effectively connected with the conduct of a trade or business within the United States. The performance of

personal services within the United States may constitute a trade or business within the United States.

The treatment of income as effectively connected with a U.S. trade or business depends upon whether the source of the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages) and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States 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 are a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected with the conduct of a trade or business in the United States (under what is referred to as a “force of attraction” rule).

The income of a nonresident alien individual from the performance of personal services within the United States is excluded from U.S.-source income, and therefore is not taxed by the United States in the absence of a U.S. trade or business, if the following criteria are met: (1) the individual is not in the United States for over 90 days during the taxable year; (2) the compensation does not exceed \$3,000; and (3) the services are performed as an employee of, or under a contract with, a foreign person not engaged in a trade or business in the United States, or are performed for a foreign office or place of business of a U.S. person.

Foreign source income generally 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. In those circumstances, only three types of foreign source income are considered to be effectively connected income: rents and royalties for the use of certain intangible property derived from the active conduct of a U.S. business; certain dividends and interest either derived in the active conduct of a banking, financing or similar business in the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office. Special rules apply for purposes of determining the foreign source income that is effectively connected with a U.S. business of an insurance company.

Any income or gain of a foreign person for any taxable year that is attributable to a transaction in another year is treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other year (section 864(c)(6)). In addition, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within ten years after the cessation of business is effectively connected with the conduct of a trade or business within the United States is made as if the sale or exchange occurred immediately before the cessation of business (section 864(c)(7)).

Canada

Nonresident individuals are subject to tax only on certain Canadian-source income. Nonresidents who earn income from employment or business in Canada must file a Canadian tax return and pay at the same rates as a resident. Nonresident corporations generally are subject to

tax on certain items of income from carrying on a business in Canada at the general Canadian tax rates. Nonresidents are considered to be carrying on business in Canada if they produce, grow, mine, create, manufacture, fabricate, improve, pack, preserve, or construct anything in Canada; or if they solicit orders or offer anything for sale in Canada through an agent or servant.⁷⁶

Proposed protocol limitations on internal law

The proposed protocol modifies Article VII of the present treaty in two ways. One modification alters the language of paragraph 2 but does not change the interpretation of the treaty. The other modification does not alter the language of the present treaty but changes the agreed interpretation of the treaty partners.

Taxation of income attributable to former permanent establishments

The proposed protocol replaces paragraph 2 of Article VII (Business Profits). As modified, paragraph 2 now provides that where a resident of a treaty country carries on, or has carried on, business in the other treaty country through a permanent establishment in that other country, both countries will attribute to permanent establishments in their respective states those business profits which the permanent establishment might be expected to make if it were a distinct and separate person engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the resident and with any other person related to the resident.

New paragraph 2 is substantially similar to paragraph 2 as it existed before the proposed protocol. However, in addition to the reference to a resident of a Contracting State who “carries on” business in the other Contracting State, the Protocol incorporates into the Convention the rule of section 864(c)(6) by adding “or has carried on” to address circumstances where, as a result of timing, income may be attributable to a permanent establishment that no longer exists in one of the treaty countries. In such cases, the income is properly within the scope of Article VII. The proposed protocol also makes conforming changes to Articles X (Dividends), XI (Interest), and XII (Royalties) of the treaty where Article VII would apply. Paragraph 5 of the General Note states that these revisions to the treaty are only intended to clarify the application of the existing provisions of the treaty.

The Technical Explanation provides the following example to illustrate the application of paragraph 2. Assume a company that is a resident of Canada and that maintains a permanent establishment in the United States winds up the permanent establishment’s business and sells the permanent establishment’s inventory and assets to a U.S. buyer at the end of year 1 in exchange for an installment obligation payable in full at the end of year 3. Despite the fact that the company has no permanent establishment in the United States in year 3, the United States may tax the deferred income payment recognized by the company in year 3 under paragraph 2.

⁷⁶ *IBFD Canada Country Survey* A.6.2.1.1.

Business profits attributable to a permanent establishment

Under the present treaty, business profits of an enterprise of a treaty country are taxable in the other treaty country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This rule is one of the basic treaty limitations on a country's right to tax income of a resident of the other country, and is similar to the rules found in the U.S. and OECD Model treaties.

Consistent with the elimination of the separate article for independent personal services, this article limits the right of a treaty country to tax income from the performance of independent personal services by a individual resident of the other treaty country in a manner similar to the limitations provided in the separate article applicable to independent personal services that is included in the present treaty.

Paragraph 9 of the General Note provides rules for the attribution of business profits to a permanent establishment. Under the present treaty, the treaty countries attribute to a permanent establishment the business profits that the permanent establishment might be expected to make if it were a distinct and separate person engaged in the same or similar activities under the same or similar conditions, and dealing wholly independently with the resident and with any other person related to the resident. The term "related to the resident" is to be interpreted in accordance with paragraph 2 of Article IX (Related Persons). The reference to other related persons is intended to make clear that the test of paragraph 2 is not restricted to independence between a permanent establishment and a home office.

Under certain circumstances, the amount of income "attributable to" a permanent establishment under Article VII may be greater than the amount of income that would be treated as "effectively connected" to a U.S. trade or business under section 864. For example, in the case of financial institutions, income from interbranch notional principal contracts may be taken into account under Article VII of the treaty, notwithstanding that such transactions may be ignored for purposes of section 864. The Technical Explanation clarifies, however, that such notional payments used to compute the profits that are attributable to a permanent establishment will not be taxed as if they were actual payments for purposes of other taxing provisions of the Convention, for example, for purposes of taxing a notional royalty under Article XII (Royalties).

The Technical Explanation states that the United States and Canada generally interpret the arm's length standard in a manner consistent with the OECD Transfer Pricing Guidelines and that the language of paragraph 2, when combined with paragraph 3 dealing with the allowance of deductions for expenses incurred for the purposes of earning the profits, incorporates the arm's length standard for purposes of determining the profits attributable to a permanent establishment. Under Paragraph 9 of the General Note, the business profits to be attributed to a permanent establishment include only the profits derived from the assets used, risks assumed, and activities performed by the permanent establishment. That paragraph and the Technical Explanation make clear that the principles of the OECD Transfer Pricing Guidelines apply for purposes of determining the profits attributable to a permanent establishment, but taking into account the different economic and legal circumstances of a single legal entity. Thus, any of the methods described in the Transfer Pricing Guidelines for determining an arm's length result, including profits methods, may be used to determine the income of the permanent establishment as long as

those methods are applied in accordance with the Transfer Pricing Guidelines. However, the use of the Transfer Pricing Guidelines applies only for purposes of attributing profits within the legal entity and it does not create legal obligations or other tax consequences that would result from transactions having independent legal significance.

As discussed above, in applying the arm's-length standard to determine the taxable business profits of a permanent establishment, the Technical Explanation observes that it is necessary to draw an economic (as well as legal) distinction between operating through a single legal entity rather than through separate legal entities. For example, an entity that operates through branches rather than separate subsidiaries will have lower capital requirements because all of the assets of the entity are available to support all of the entity's liabilities (with some exceptions attributable to local regulatory restrictions). Thus, most commercial banks and some insurance companies operate through branches rather than subsidiaries. While the benefit that comes from such lower capital costs must be allocated among the branches in an appropriate manner, this issue does not arise in the case of an enterprise that operates through separate entities because each entity must either be capitalized separately or compensate another entity for providing capital (e.g., through a guarantee).

The Technical Explanation states that, whereas U.S. internal law does not recognize internal transactions because they do not have legal significance, the rule provided by the paragraph 9 of the General Note is that such internal dealings may be used to allocate income in cases where the dealings accurately reflect the allocation of risk within the enterprise. For example, in the case of global dealing in securities, many banks use internal swap transactions to transfer risk from one branch to a central location where traders have the expertise to manage that particular type of risk. Under the proposed protocol, such banks also are permitted to use swap transactions as a means of allocating income between or among the branches, provided the allocation method used by the bank complies with the transfer pricing rules of U.S. internal law. However, the books of a branch will not be respected if the results are inconsistent with a functional analysis. For example, income from a transaction that is booked in a particular branch (or home office) would not be allocated to that location if the sales and risk management functions that generate such income are performed in another location.

A permanent establishment cannot be funded entirely with debt, but must have sufficient capital to carry on its activities as if it were a distinct and separate enterprise. In general, if insufficient capital has been attributed to a permanent establishment for profit attribution purposes, a treaty country may attribute such capital to the permanent establishment, in accordance with the arm's-length principle, and deny an interest deduction to the extent necessary to reflect that capital attribution. According to the Technical Explanation, both U.S. internal law and the proposed protocol start from the premise that all of the capital of the enterprise supports all of the assets and risks of the enterprise, and therefore the entire capital of the enterprise must be allocated to its various businesses and offices.

The Technical Explanation notes, however, that U.S. internal law⁷⁷ does not take into account the fact that some assets are more risky than other assets, and that, for example, an independent enterprise would require less capital to support a perfectly hedged U.S. Treasury security than it would to support an equity security or other asset with significant market and/or credit risk. Thus, U.S. internal law requires taxpayers in some cases to allocate more capital to the United States (and, thus, reduces the taxpayer's interest deduction more) than may be appropriate. To address these cases, the Technical Explanation states that the proposed protocol permits taxpayers to apply a more flexible approach that takes into account the relative risk of its assets in the various jurisdictions in which it conducts business. In particular, paragraph 9 of the General Note provides that, with respect to financial institutions other than insurance companies, a treaty country may determine the amount of capital to be attributed to a permanent establishment by allocating the institution's total equity between its various offices on the basis of the proportion of the financial institution's risk-weighted assets attributable to each of them. However, to ease the administrative burden arising because risk-weighting is more complicated than the method prescribed under U.S. internal law, the Technical Explanation also states that taxpayers may choose to apply the principles of U.S. internal law, rather than risk-weighted attribution, even if the taxpayer has otherwise chosen to apply Article VII in lieu of the effectively connected income rules of U.S. internal law. However, the Technical Explanation further provides that a taxpayer's election to apply the principles of U.S. internal law is not binding for purposes of Canadian taxation unless the result is in accordance with the arm's length principle.

Paragraph 9 of the General Note provides that, in the case of an insurance company, there must be attributed to a permanent establishment not only premiums earned through the permanent establishment, but also that portion of the insurance company's overall investment income from reserves and surplus that supports the risks assumed by the permanent establishment.

The Technical Explanation states that the understanding of the treaty countries expressed in paragraph 9 of the General Note affects the interpretation of paragraph 3 of Article VII of the treaty, which provides that in computing taxable business profits of a permanent establishment, deductions are allowed for expenses, wherever incurred, that are for the purposes of the permanent establishment. These deductions include executive and general administrative expenses so incurred. The Technical Explanation states that deductions are allowed regardless of which accounting unit of the enterprise books the expenses, so long as the expenses are incurred for the purposes of the permanent establishment. The amount of expense that must be allowed as a deduction is determined by applying the arm's-length principle. The Technical Explanation states that a permanent establishment may deduct payments made to its head office or another branch in compensation for services performed for the benefit of the branch, provided the deduction comports to the arm's-length standard. The permissible method for computing the amount of such a deduction would depend upon the terms of the arrangements between the branches and head office.

⁷⁷ Treas. Reg. sec. 1.882-5.

Article 5. Dividends

The proposed protocol makes several amendments to Article X (Dividends) of the present treaty. Article X of the present treaty generally allows full residence-country taxation and limited source-country taxation of dividends. The present treaty includes a generally applicable maximum rate of withholding at source of 15 percent and a reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. Special rules apply to dividends received from RICs and REITs.

The proposed protocol replaces paragraph 2(a) of Article X of the present treaty. Paragraph 2(a), in both its present and proposed form, provides that a treaty country may tax dividends paid by a company resident in that country to a resident of the other treaty country at a rate not in excess of five percent if the beneficial owner of the dividends is a company that owns at least 10 percent of the voting stock of the dividend-paying company. Proposed paragraph 2(a) adds a parenthetical to this provision that provides that, for this purpose, a company that is a resident of a treaty country is considered to own the voting stock owned by an entity that is considered fiscally transparent under the laws of that country and that is not a resident of the treaty country of which the company paying the dividends is a resident, in proportion to the company's ownership interest in that entity. The Technical Explanation states that the United States views this parenthetical as merely a clarification.

The proposed protocol replaces paragraph 3 of Article X of the present treaty, which defines the term "dividends." The proposed protocol generally defines dividends as income from shares or other corporate participation rights that are not treated as debt, as well as other amounts that are subjected to the same tax treatment by the source country as income from shares (for example, constructive dividends). The Technical Explanation states that the term is defined broadly and flexibly; the term is intended to cover all arrangements that might yield a return on an equity investment in a corporation as determined under the tax laws of the source country, as well as arrangements that might be developed in the future. The General Note states that it is understood that distributions from Canadian income trusts and royalty trusts that are treated as dividends under the taxation laws of Canada are considered dividends.

The proposed protocol replaces paragraph 4 of Article X of the present treaty. Proposed paragraph 4 provides that the treaty's reduced rates of tax on dividends do not apply if the dividend recipient carries on, or has carried on, business through a permanent establishment in the source country and the holding in respect of which the dividends are paid is effectively connected with that permanent establishment. In this case, the dividends are taxed as business profits (Article VII). According to the Technical Explanation, proposed paragraph 4 is substantially similar to paragraph 4 in the present treaty, except that it adds clarifying language consistent with changes made in other articles of the proposed protocol with respect to income attributable to a permanent establishment that has ceased to exist.

The proposed protocol amends paragraph 5 of Article X of the present treaty to eliminate the words "or a fixed base." This change is consistent with Article 9 of the proposed protocol.

The proposed protocol replaces paragraph 7(c) of Article X of the present treaty, which provides special rules that apply to dividends paid by U.S. REITs. Under proposed paragraph

7(c), the five-percent rate of withholding tax is denied to dividends paid by REITs. The 15-percent rate of withholding is allowed for dividends paid by a REIT, provided one of three additional conditions is met: (1) the beneficial owner of the dividend is an individual holding an interest of not more than 10 percent in the REIT; (2) the dividend is paid with respect to a class of stock that is publicly traded, and the beneficial owner of the dividend is a person holding an interest of not more than five percent of any class of the REIT's stock; or (3) the beneficial owner of the dividend holds an interest in the REIT of not more than 10 percent, and the REIT is diversified (that is, the value of no single interest in real property held by the REIT exceeds 10 percent of the total interests of the REIT in real property). Where an estate or testamentary trust acquired its interest in a REIT as a consequence of an individual's death, for purposes of this provision, the estate or trust is deemed, with respect to that interest, to be an individual for the five-year period following the death.

The Technical Explanation indicates that the restrictions on availability of the lower rate are intended to prevent the use of REITs to gain inappropriate U.S. tax benefits. For example, a company resident in Canada could directly own U.S. real property and pay U.S. tax either at a 30-percent rate of withholding on the gross income or at graduated rates on the net income. Absent the additional REIT restrictions, there is a concern that such a company instead might place the real property in a REIT, which might be established as a mere conduit, and thereby significantly reduce the U.S. tax that otherwise would be imposed (transforming income from the sale of real property into dividends taxable under the treaty at five percent). In the cases in which proposed paragraph 7(c) permits a dividend from a REIT to be eligible for the 15-percent maximum rate of withholding tax, the holding in the REIT is not considered the equivalent of a direct holding in the underlying real property.

Article 6. Interest

Internal taxation rules

United States

Subject to several exceptions (such as those for portfolio interest, bank deposit interest, and short-term original issue discount), the United States imposes a 30-percent withholding tax on U.S.-source interest paid to foreign persons under the same rules that apply to dividends. U.S.-source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that satisfies specified foreign business requirements. Also subject to the 30-percent tax is interest paid by the U.S. trade or business of a foreign corporation. A foreign corporation is subject to a branch-level tax on certain "excess interest" of a U.S. trade or business of that corporation. Under this rule, an amount equal to the excess of the interest deduction allowed to the U.S. business over the interest paid by the business is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to the 30-percent withholding tax.

Portfolio interest generally is defined as any U.S.-source interest that is not effectively connected with the conduct of a trade or business if the interest (1) is paid on an obligation that satisfies certain registration requirements or specified exceptions and (2) is not received by a 10-

percent owner of the issuer of the obligation, taking into account shares owned by attribution. The portfolio interest exemption does not apply to certain contingent interest income.

If an investor holds an interest in a fixed pool of real estate mortgages that is a real estate mortgage interest conduit (“REMIC”), the REMIC generally is treated for U.S. tax purposes as a pass-through entity, and the investor is subject to U.S. tax on a portion of the REMIC’s income (generally, interest income). If the investor holds a so-called “residual interest” in the REMIC, the Code provides that a portion of the net income of the REMIC that is taxed in the hands of the investor—referred to as the investor’s “excess inclusion”—may not be offset by any net operating losses of the investor, must be treated as unrelated business income if the investor is an organization subject to the unrelated business income tax, and is not eligible for any reduction in the 30-percent rate of withholding tax (by protocol or otherwise) that would apply if the investor otherwise were eligible for such a rate reduction.

Canada

In the absence of a treaty, Canadian-source interest income derived by nonresidents is, subject to certain exceptions, subject to withholding tax at a rate of 25 percent of the gross amount of the interest.

Proposed protocol limitations on internal law

The proposed protocol replaces the interest article of the existing treaty with new rules. Under the proposed new rules, interest arising in one treaty country (the source country) and beneficially owned by a resident of the other treaty country generally is exempt from tax in the source country. This exemption from source-country tax is similar to that provided in the U.S. Model treaty. Under the existing treaty, by contrast, the source country may tax the interest at a rate not exceeding 10 percent.

Like the existing treaty, the proposed protocol defines interest as income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits. In particular, interest includes income from government securities and from bonds or debentures, including premiums and prizes attaching to those securities, bonds, or debentures. The term “interest” also includes all other income that is treated as income from money lent under the tax law of the treaty country in which the income arises. Interest does not include income covered in Article X (Dividends).

The exemption from source country taxation does not apply if the beneficial owner of the interest carries on or has carried on business through a permanent establishment in the source country and the debt-claim in respect of which the interest is paid is effectively connected with that permanent establishment. In that circumstance the interest is taxed as business profits (Article VII of the treaty). With two exceptions, these rules are the substantially the same as the rules in the existing treaty. First, the phrase “or has carried on” does not appear in the existing treaty. By adding that phrase, the proposed protocol clarifies that the rule for a debt-claim that is effectively connected with a permanent establishment applies to income attributable to a permanent establishment that no longer exists at the time the income is derived. The notes to the proposed protocol state that the reference to business formerly having been carried on through a

permanent establishment confirms the negotiators' shared understanding of the meaning of existing provisions and therefore is nothing more than clarifying. Second, consistent with the proposed protocol's deletion of the independent personal services article and in contrast with the rules in the existing treaty, the rules just described do not refer to interest effectively connected with a fixed base from which independent personal services are provided. References to a fixed base also have been deleted elsewhere in the interest article.

Interest is considered to arise in a treaty country when the payor of the interest is the government or a political subdivision or local authority of that country or is a resident of that country. If, however, the person paying the interest has a permanent establishment in a country other than the person's country of residence, the indebtedness on which the interest is paid was incurred in connection with that permanent establishment, and the interest is borne by (allowable as a deduction in computing the taxable income of) that permanent establishment, the interest is deemed to arise in the country in which the permanent establishment is situated, not in the country of residence of the payor.

Like the existing treaty, the proposed protocol addresses non-arm's-length interest charges between a payer and a beneficial owner that have a special relationship. Paragraph 5 of Article 6 provides that the article applies only to the amount of interest that would have been agreed in the absence of a special relationship. Any excess amount is taxable according to the laws of each treaty country, with due regard being given to other provisions of the treaty. For example, excess interest paid to a parent corporation may be treated as a dividend under a country's internal laws and, accordingly, would be entitled to the benefits of Article X (Dividends). In explanations of similar provisions in other recent treaties, the Treasury Department has noted the United States considers the term "special relationship" to include relationships that involve control as defined under the transfer pricing rules of section 482.

The proposed protocol provides two anti-abuse exceptions to the general source-country exemption from tax on interest. The first exception relates to contingent interest payments. The rules for interest arising in the United States and interest arising in Canada are stated differently. Interest arising in the United States that is contingent interest of a type that does not qualify as portfolio interest under U.S. law may be taxed in the United States. The Technical Explanation states that contingent interest is defined by reference to section 871(h)(4) and that the exceptions from contingent interest under section 871(h)(4)(C) apply. If interest arising in Canada is determined with reference to (1) receipts, sales, income, profits, or other cash flow of the debtor or a related person, (2) any change in the value of any property of the debtor or a related person, or (3) any dividend, partnership distribution, or similar payment made by the debtor or a related person, the interest may be taxed in Canada in accordance with Canadian law. If the beneficial owner of contingent interest arising in either the United States or Canada is a resident of the other treaty country, the interest may not be taxed at a rate exceeding 15 percent (that is, the rate prescribed for dividends derived by less-than-10-percent shareholders).

The second anti-abuse exception provides that the exemption from source-country taxation does not apply to interest that is an excess inclusion with respect to a residual interest in a REMIC. That interest may be taxed by each treaty country in accordance with its domestic law. The Technical Explanation states that this exception is consistent with the policy of sections 860E(e) and 860G(b) that excess inclusions with respect to a REMIC should bear full

U.S. tax in all cases. The Technical Explanation also notes that although the provision for REMICs is written reciprocally, at the time the proposed protocol was signed the provision had no application to Canadian-source interest because Canada did not provide for REMICs in its internal tax law.

Like the existing treaty, the proposed protocol provides that if a resident of one treaty country pays interest to a person who is not a resident of the other treaty country, that other treaty country generally may not impose any tax on that interest. The other treaty country may impose tax on that interest only if the interest arises in that treaty country or if the indebtedness in respect of which the interest is paid is effectively connected with a permanent establishment situated in that treaty country.

The Technical Explanation notes that notwithstanding the limitations on source-country taxation of interest, the saving clause permits the United States to tax its residents and citizens, subject to the treaty's special foreign tax credit rules, as if the treaty had not entered into force.

Article 27 of the proposed protocol provides rules for phasing in exclusive residence country taxation of cross-border related-party interest payments. Those rules are described below in the explanation of Article 27.

Article 7. Royalties

Internal taxation rules

United States

Under the same system that applies to dividends and interest, the United States imposes a 30-percent withholding tax on U.S.-source royalties paid to foreign persons. U.S.-source royalties include royalties for the use of or right to use intangible property in the United States.

Canada

Under Canadian domestic law, a 25-percent withholding tax is imposed on Canadian-source royalties. However, royalties for the production or reproduction of literary, dramatic, musical and artistic works are exempt from Canadian tax when paid to a nonresident (regardless of whether the payment is made to a treaty or nontreaty country). The domestic law exemption does not apply to payments for a right in, or the use of, motion picture films or films, videotapes or other means of reproduction for use in connection with television.

Proposed treaty limitations on internal law

Article 7 (Royalties) of the proposed protocol modifies Article XII (Royalties) of the present treaty by deleting paragraph 5 and 6(a) of Article XII (Royalties) and replacing them with new articles conforming to the proposed elimination of Article XIV (Independent Personal Services). Similarly, this article further conforms Article XII (Royalties) of the present treaty to this change by striking the concept of a "fixed base" throughout.

In addition to these conforming changes, the proposed protocol modifies the scope paragraph 5 of the present treaty. Pursuant to paragraph 5, the reduced royalty rates of paragraphs 2 and 3 are not available to the beneficial owner of the royalties if three criteria are met: (1) the beneficial owner is resident in one treaty country but also carries on business in the other treaty country through a permanent establishment; (2) the royalties arise in that other treaty country; and (3) the royalty is paid in connection with a right or property that is effectively connected to that permanent establishment. In proposed paragraph 5, the first criteria will apply to persons who carry on, or have carried on, business in the other treaty country through a permanent establishment. The diplomatic notes exchanged in connection with this proposed protocol explain that the added phrase “or have carried on” is intended to clarify the treatment of income attributable to a permanent establishment that has ceased to exist.

The diplomatic notes also clarify the provisions of subparagraph 3(c) of Article XII (Royalties). Pursuant to that subparagraph, royalty withholding is eliminated with respect to payments made in connection with the use of, or right to use, any patent or any information concerning industrial, commercial or scientific experience. However, this subparagraph carves out payments made for information provided in connection with a franchise agreement. As explained by the diplomatic notes, this carve-out is limited to information that governs, or otherwise deals with, the operation of the franchise. It does not affect information concerning industrial, commercial or scientific experience that is held for resale or license. Accordingly, payments made for such information are subject to paragraph 3(c) and are exempt from withholding tax.

Article 8. Gains

The proposed protocol makes several amendments to Article XIII (Gains) of the present treaty. Article XIII of the present treaty provides rules for the taxation of gains from the sale of property by a resident of a treaty country. Paragraphs 1 and 2 of the article permit the source country to tax gains derived by a resident of one treaty country from (1) the alienation of real property situated in the other country and (2) the sale of personal property forming part of the business property of a permanent establishment in the other country.

The proposed protocol replaces paragraph 2 of Article XIII of the present treaty. Both existing paragraph 2 and the new paragraph 2 included in the proposed protocol permit a treaty country to tax gains from the alienation of personal property that forms a part of the business property of a permanent establishment that a resident of the other treaty country has or had (within the 12-month period preceding the date of alienation) in the first treaty country. This rule permits source-country taxation of gains from the alienation of the permanent establishment. Consistent with Article 9 of the proposed protocol, however, new paragraph 2 does not include any reference to personal property pertaining to a fixed base or to the performance of independent personal services.

The proposed protocol replaces paragraph 5 of Article XIII of the present treaty. Generally, paragraph 5, in both its present and proposed form, provides an exception to Article XIII’s default rule that gains from property other than the property identified in the first three paragraphs of Article XIII may be taxed only in the treaty country in which the person alienating the property is a resident. The exception in proposed paragraph 5 provides that a treaty country

may, according to its domestic laws, tax gains from the alienation on any property derived by an individual resident in the other treaty country if two requirements are satisfied. The first requirement is that the individual was a resident of the treaty country seeking to tax the gain (a) for at least 120 months during any period of 20 consecutive years preceding the alienation of the property and (b) at any time during the 10-year period immediately preceding the alienation of the property. The second requirement is that the property (or property for which such property was substituted in a nonrecognition transaction) (a) was owned by the individual at the time the individual ceased to be a resident of the treaty country seeking to tax the gain and (b) was not a property that the individual was treated as having alienated by reason of ceasing to be a resident of the treaty country seeking to tax the gain and becoming a resident of the other treaty country.

Proposed paragraph 5 is substantially the same as present paragraph 5, except that proposed paragraph 5 adds condition (b) to the second requirement. The Treasury Explanation states that this addition reflects the fact that the main purpose of paragraph 5—ensuring that gains that accrue while an individual is resident in one treaty country remain taxable in that treaty country for the stated time after the individual moves to the other treaty country—is met if the pre-emigration gain is taxed in the treaty country the individual is departing immediately before the departure.

The proposed protocol replaces paragraph 7 of Article XIII of the present treaty. According to the Technical Explanation, paragraph 7, in both its present and proposed form, is intended to coordinate U.S. and Canadian taxation of gains in the case of a timing mismatch. For example, a mismatch may occur if a Canadian resident is deemed, for Canadian tax purposes, to recognize capital gain upon emigrating from Canada to the United States. Another example of a situation in which a mismatch may occur is a gift that Canada deems to be an income producing event for its tax purposes but with respect to which the United States defers taxation while assigning the donor's basis to the donee. Present paragraph 7 addresses such timing mismatches by allowing the individual to elect to be liable to tax in the treaty country that is deferring taxation as if the individual had sold and repurchased the property for an amount equal to its fair market value at a time immediately prior to the deemed alienation. This election is not available to certain non-U.S. citizens subject to tax in Canada by virtue of a deemed alienation because such individuals cannot elect to be liable to tax in the United States.

The proposed protocol replaces the present election with an election to be treated for tax purposes in one treaty country as having sold and repurchased the property for its fair market value immediately before the taxable event in the other treaty country. According to the Technical Explanation, the new election will be available to any individual who emigrates from Canada to the United States, without regard to whether the person is a U.S. citizen immediately before ceasing to be a resident of Canada. If the individual is not subject to U.S. tax at that time, the effect of the election is to give the individual an adjusted basis in the property for U.S. tax purposes equal to the property's fair market value as of the date of the deemed alienation in Canada; the result is that only post-emigration gain will be subject to U.S. tax when there is an actual alienation. If the Canadian resident is also a U.S. citizen at the time of his or her emigration from Canada, or would otherwise be subject to U.S. tax on his or her disposition of the property, then the election would allow the person to accelerate the tax under U.S. tax law and allow credits to be used to avoid double taxation.

Generally, the rule in proposed paragraph 7 does not apply in the case of death. In addition, if there are losses and gains in one treaty country from deemed alienations of different properties, then proposed paragraph 7 must be applied consistently within the taxable period with respect to all such properties. In such a case, however, proposed paragraph 7 will apply only if the deemed alienations of the properties result in a net gain. Finally, the election in proposed paragraph 7 is available only with respect to property that is subject to a treaty country's deemed disposition rules and with respect to which gain on a deemed alienation is recognized for that treaty country's tax purposes in the taxable year of the deemed alienation.

The proposed protocol amends paragraph 9(c) of Article XIII of the present treaty to eliminate the words "or pertained to a fixed base." This change is consistent with Article 9 of the proposed protocol.

Article 9. Independent Personal Services

The proposed protocol deletes Article XIV (Independent Personal Services) from the treaty, consistent with the U.S. and OECD Model treaties. Paragraph 4 of the General Note confirms the understanding that there is no practical distinction between the terms "fixed base" and "permanent establishment." Therefore, under the proposed protocol, income derived from independent personal services is considered to be business profits under Article VII of the treaty.

The proposed protocol makes numerous technical conforming changes to reflect the deletion of Article XIV.

Article 10. Income From Employment

Article 10 of the proposed protocol modifies Article XV (Dependent Personal Services) of the present treaty. In general, the proposed changes conform this article to the U.S. and OECD Model treaties. First, the article is renamed, from "Dependent Personal Services" to "Income from Employment." Next, the proposed protocol replaces paragraph 1, which has the effect of broadening its scope with respect to the types of remuneration covered by this provision. This is achieved by striking the word "similar" from the phrase "other similar remuneration." Thus, as proposed, Article XV (Income from Employment) will now apply to salaries, wages and other remuneration. According to the Technical Explanation, this change clarifies that, consistent with the U.S. and OECD Model treaties, the article applies to any type of remuneration derived in connection with employment, including payments in kind.

Second, the proposed protocol replaces paragraph 2. This provision applies to remuneration for employment in the other treaty country, and describes limits on the taxation by the other treaty country.

Currently, subparagraph 2(a) of the present treaty describes a test where such remuneration is ten thousand dollars (\$10,000) or less, and subparagraph 2(b) describes a test where the person receiving the remuneration is present in the other treaty country for less than 183 days. Under the present treaty, these limitations expressly apply with respect to each calendar year. While the "in a calendar year" reference is deleted by the proposed protocol, the Technical Explanation clarifies that the ten thousand dollar (\$10,000) test is still determined on a

calendar year basis. Thus, the change to the period of measurement impacts only the “days present” test.

With respect to the days present test, the proposed protocol conforms the present treaty to the U.S. and OECD Model treaties. Rather than measuring the days present in any given calendar year, the proposed protocol looks to whether the individual is present in the other treaty country for more than 183 days, in aggregate, in any twelve-month period that either starts or ends during the relevant tax year. For example, if the relevant tax year is calendar year 2011 (and assuming that the protocol is in effect), an individual may have been continuously present in the other treaty country from October 1, 2010 through December 31, 2010, and again from July 1, 2011 through September 30, 2011. In this case, the days present test will not exempt this person from taxation by the other treaty country with respect to remuneration paid for services performed during 2011 because between October 1, 2010 and September 30, 2011 (a twelve-month period ending during the relevant tax year) that individual is present in the other state for more than 183 days—even though the person is not actually present in the other treaty country for more than 183 during calendar year 2011.

The days present test is also modified with respect to one of its two additional criteria. Specifically, the remuneration cannot be paid by, or on behalf of, a person that is resident in the other treaty country. Previously, this paragraph referred to payments by an employer resident in the other treaty country. While the U.S. and OECD Model treaties both use the term “employer” in this context, the Technical Explanation acknowledges that this change responds to certain abusive cases involving the recharacterization of employment relationships. In these abusive cases, intermediary employers have been interposed to avoid direct remuneration by a person in the other treaty country—even though the intermediary employer had little or no rights, responsibilities or risk with respect to the services being performed.

In addition, the proposed protocol conforms the present treaty to the proposed elimination of Article XIV (Independent Personal Services) by eliminating its prior reference to a “fixed base which the employer has in that other treaty country.”

The diplomatic notes exchanged in connection with the proposed protocol expand on the changes made by the proposed protocol by setting forth new concepts regarding remuneration deferred to the future through stock option grants. Generally, such income is taxable in the country of residence at the time the stock options are disposed of or exercised. However, the diplomatic notes provide for the allocation of income from stock options between the U.S. and Canada based on the number of days the principal place of employment is situated in each country during the period that starts with the stock option grant and ends with the exercise or disposal of that option. In determining whether income from the exercise or disposal of an option is subject to these rules, the days present and income earned tests of paragraph 2 of Article XV (Income from Employment) (as modified by this proposed protocol) must be applied. However, these tests are applied with respect to the year in which the relevant services were performed, and not with respect to the year in which the stock options were disposed of or exercised.

The allocation described in the diplomatic notes is predicated on a traditional stock option grant, such that the grant does not immediately effectuate a transfer of ownership. If,

instead, the competent authorities of both treaty countries agree that the stock option effectuates an immediate transfer of ownership, then the diplomatic notes authorize the competent authorities to attribute income accordingly. Factors indicating an immediate transfer of ownership include the granting of options that are (1) “in the money” at the time of the grant or (2) not subject to a substantial vesting period.

The treatment of stock options, as described in the diplomatic notes, differs from both the U.S. and OECD Model treaties in that it provides the express terms for allocating income from the exercise or disposal of an option between the two treaty countries. While the definitions of remuneration in both the U.S. and OECD Model treaties include such income, neither provides terms for allocating it between treaty countries.

Article 11. Artistes and Athletes

Article XVI (Artistes and Athletes) of the treaty contains rules applicable to entertainers and athletes. The proposed protocol makes two conforming changes to Article XVI of the treaty. First, it replaces references to Article XIV (Independent Services) with references to Article VII (Business Profits) to reflect the relocation of the provisions addressing independent services from Article XIV to Article VII of the treaty. Second, the proposed protocol replaces references to “Article XV (Dependent Personal Services)” with references to “Article XV (Income from Employment)” to reflect that the protocol changes the title of Article XV.

Article 12. Withholding of Taxes on Independent Personal Services

The proposed protocol deletes Article XVII (Withholding of Taxes in Respect of Personal Services) from the present treaty, consistent with the U.S. and OECD Model treaties. This change conforms to the deletion of the Article XIV (Independent Personal Services) by Article 9 of the proposed protocol, under which business profits of an individual resident in a treaty country attributable to his independent personal services rendered in the other treaty country are treated in the same manner as any other business profits under Articles V (Permanent Establishment) and VII (Business Profits) of the treaty.

Article 13. Pensions and Annuities

Article XVIII (Pensions and Annuities) of the present treaty provides several rules governing the treatment of cross-border pension distributions. Some of these rules are similar to those in the U.S. Model treaty, as more fully described below, while some are different. The proposed protocol modifies some of the existing treaty rules, mostly to address Roth individual retirement accounts (“IRAs”), and adds several new paragraphs to the treaty that address cross-border pension contributions and benefits accruals. Many of the new rules are similar to those found in the U.S. Model treaty, but several reflect the uniquely large cross-border flow of personal services between Canada and the United States, including the large number of cross-border commuters. In addition, the proposed protocol adds a new provision to address the source of certain annuity or life insurance payments made by branches of insurance companies.

Present treaty rules relating to pensions and annuities

Taxation of cross-border “pensions”

The present treaty differs from the U.S. Model treaty and many recent U.S. tax treaties in that it permits both residence and source country taxation of pension distributions. The U.S. Model treaty provides only for residence country taxation. Under both the present treaty and the U.S. Model treaty, “pensions” arising in a treaty country and paid to a resident of the other country may be taxed in the residence country, but only to the extent that the payment would be subject to tax if the recipient were a resident of the source country. Under the present treaty, the source country may tax such cross-border pension distributions as well, but in the case of periodic pension payments, only up to 15 percent of the gross amount of such payments. Paragraph 3 of Article XVIII of the present treaty provides that the term “pensions” includes any payment under a superannuation, pension, or other retirement arrangement, Armed-Forces retirement pay, war veterans pensions and allowances, and amounts paid under a sickness, accident, or disability plan, but does not include payments under an income-averaging annuity contract or social security benefits, which (including social security benefits in respect of government services) are subject to paragraph 5 of Article XVIII.

Deferral election rule for pensions

In addition, under the present treaty, an individual who is a citizen or resident of a treaty country and who is a beneficiary of an arrangement that is a resident of the other treaty country, generally tax exempt in that other country, and operated exclusively to provide pension, retirement, or employee benefits, may elect to defer taxation in his country of residence on undistributed income accruals of the arrangement (or an arrangement substituted therefor) until and to the extent that a distribution is made. The provision provides that the election is made “under” rules established by the competent authority of the recipient’s treaty country. As of the date the proposed protocol was signed (September 21, 2007), the competent authority of the United States, but not the competent authority of Canada, had prescribed rules pertaining to the election.⁷⁸

Treatment of annuities under U.S. domestic law and present treaty rules

Under the present treaty, the term “annuity” means a stated sum paid periodically at stated times during life or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration other than services rendered, but does not include a payment that is not periodic or any annuity the cost of which was deductible for tax purposes in the treaty country in which the annuity was acquired.

Payments of annuities under, and withdrawals of cash value from, life insurance or annuity contracts issued by a U.S. life insurance company, including a foreign branch of a U.S. life insurance company, are U.S.-source income that are generally subject to a 30-percent

⁷⁸ See Rev. Proc. 2002-23, 2002-1 C.B. 744.

withholding tax under sections 871(a) and 1441 when paid to a nonresident alien individual.⁷⁹ If such a payment is an annuity as defined under the present treaty, it is generally subject to a 15-percent withholding tax under subparagraph 2(b) of Article XVIII of the treaty. If the payment is not an “annuity” under the treaty, it may, depending on its nature, be subject to an unreduced 30-percent withholding tax under paragraph 1 of Article XXII (Other Income), unless it is covered under another article of the treaty.

Proposed protocol limitations on internal law and modifications to the present treaty with respect to pensions

Taxation of cross-border Roth IRAs

The proposed protocol restates the present treaty definition of pensions while adding a new portion of that definition relevant to Roth IRAs. According to the Technical Explanation, the term “pensions” broadly includes pensions paid by private employers (including pre-tax and Roth 401(k) arrangements), pensions paid in respect of government services (which are covered in the government services article of the U.S. Model treaty), payments from IRAs in the United States, and payments from registered retirement savings plans (“RRSPs”) and registered retirement income funds (“RRIFs”) in Canada.

Under the proposed protocol, the term “pensions” also includes a Roth IRA (as defined in section 408A) or a similar plan or arrangement created pursuant to legislation enacted by either treaty country after the date the proposed protocol was signed that the competent authorities agree is similar to a Roth IRA. Therefore, distributions from a Roth IRA (as well as other IRAs) to a resident of Canada generally continue to be exempt from Canadian tax to the extent they would have been exempt from U.S. tax if paid to a resident of the United States. In addition, residents of Canada generally may elect to defer any taxation in Canada with respect to income accrued in a Roth IRA but not distributed by the Roth IRA, until and to the extent that a distribution is made from the Roth IRA (or any plan substituted therefor). The general rule for Roth IRAs is the same as that in the U.S. Model treaty.

However, the proposed protocol varies from the U.S. Model treaty by qualifying the above definition to provide that if an individual who is a resident of Canada makes a contribution to a Roth IRA (or to a similar plan or arrangement described above) while a resident of Canada, other than rollover contributions from another Roth IRA (or from a similar plan or arrangement described above), the Roth IRA will cease to be considered a “pension” at that time with respect to accretions from the time of such contribution. Thus, income accretions from such time will be subject to tax in Canada in the year of accrual and the Roth IRA will be hypothetically bifurcated

⁷⁹ Rev. Rul. 2004-75, 2004-2 C.B. 109. Rev. Rul. 2004-97, 2004-2 C.B. 516, provides that Rev. Rul. 2004-75 is not to be applied to payments that were made by foreign branches before January 1, 2005, provided that such payments were made pursuant to binding life insurance or annuity contracts issued on or before July 12, 2004.

into a “pension” that continues to be subject to the aforesaid rules applicable to pensions and a non-“pension” account that is not subject to such rules.⁸⁰

The Technical Explanation provides the following example of the treatment of such a bifurcated Roth IRA. In the example, an individual becomes a resident of Canada on July 1, 2008. He has a Roth IRA with a balance of \$1,100 on that date. He elects under the present treaty to defer any taxation in Canada with respect to income accrued in his Roth IRA while he is a resident of Canada. He makes no additional contributions to his Roth IRA until July 1, 2010, when he makes an after-tax contribution of \$100. There are income accretions of \$20 during the period July 1, 2008 through June 30, 2010, which are not taxed in Canada by reason of the deferral election. During the period July 1, 2010 through June 30, 2015, there are additional income accretions of \$50 which, under the proposed protocol, are subject to tax in Canada in the year of accrual. On July 1, 2015, while still a resident of Canada, he receives a lump-sum distribution of \$1,270 from his Roth IRA. The \$1,120 that was in the Roth IRA on June 30, 2010 is treated as a distribution from a pension plan that is exempt from tax in Canada to the extent that it would be exempt from tax in the United States under the Code if paid to a resident of the United States. The remaining \$150 comprises the after-tax contribution of \$100 in 2010 and accretions of \$50 that are subject to Canadian tax in the year of accrual.

Deferral election rule and Roth IRAs

The proposed protocol also modifies the deferral election rule of the present treaty in two ways. First, the proposed protocol changes the phrase “pension, retirement, or employee benefits” to “pension or employee benefits.” The Technical Explanation states that the sole purpose of this change is to reflect the fact that in certain cases, as discussed above, a Roth IRA will not be treated as a “pension.” Thus, the owner of such a Roth IRA could not elect to defer taxation in his country of residence on undistributed income accruals. The second change is that “under” is changed to “subject to” to make it clear that an election to defer taxation may be made whether or not the competent authority of the first-mentioned country (i.e., Canada) has prescribed rules for making an election.

Cross-border pension contributions

The proposed protocol adds ten new paragraphs (8 through 17) to Article XVIII of the treaty to address cross-border pension contributions (the “cross-border pension contribution provisions”). These rules are intended to remove barriers to the flow of personal services between the two treaty countries that could otherwise result from discontinuities in the laws of the treaty countries regarding the deductibility or exclusion of pension contributions.

The cross-border pension contribution provisions address three cross-border work scenarios: (1) short-term cross-border assignments, (2) cross-border commuters, and (3) U.S. citizens resident in Canada. In each of these scenarios, the individual must be a participant in a

⁸⁰ The Technical Explanation states, however, that it is understood by the treaty countries that, following a rollover contribution from a Roth 401(k) arrangement to a Roth IRA, the Roth IRA will continue to be treated as a pension subject to the rules of Article XVIII.

“qualifying retirement plan,” as defined in the proposed protocol. The U.S. Model treaty and a number of recent U.S. treaties address scenarios (1) and (3).

Definition of qualifying retirement plan

The proposed protocol defines the term “qualifying retirement plan” for purposes of the cross-border pension contribution provisions. A qualifying retirement plan in a treaty country is a trust, company, organization, or other arrangement (a) that is a resident of that country, generally exempt from income taxation in that country and operated primarily to provide pension or retirement benefits; (b) that is not an individual arrangement in respect of which the individual’s employer has no involvement; and (c) which the competent authority of the other treaty country agrees generally corresponds to a pension or retirement plan established in and recognized for tax purposes in that country. As described below, paragraph 10 of the General Note lists plans that have been pre-approved as qualified retirement plans under (c) above.

Paragraph 10 of the General Note provides that the types of Canadian plans that constitute qualifying retirement plans include certain specified plans and any identical or substantially similar plan that is established pursuant to legislation introduced after the date of signature of the proposed protocol. These specified Canadian plans are registered pension plans under section 147.1 of the Income Tax Act, RRSPs under section 146 that are part of a group arrangement described in subsection 204.2(1.32), deferred profit sharing plans under section 147, and any RRSP under section 146 or RRIF under section 146.3 that is funded exclusively by rollover contributions from one or more of the preceding plans.

Paragraph 10 of the General Note also provides that the types of U.S. plans that constitute qualifying retirement plans include certain specified plans and any identical or substantially similar plan that is established pursuant to legislation introduced after the date of signature of the proposed protocol. These specified U.S. plans are qualified plans under section 401(a) (including section 401(k) arrangements), individual retirement plans that are part of a simplified employee pension plan that satisfies section 408(k), section 408(p) simple retirement accounts, section 403(a) qualified annuity plans, section 403(b) plans, section 457(g) trusts providing benefits under section 457(b) plans, the Thrift Savings Fund (section 7701(j)), and any IRA under section 408(a) that is funded exclusively by rollover contributions from one or more of the preceding plans.

Thus, according to the Technical Explanation, U.S. IRAs and Canadian RRSPs are generally not treated as qualifying retirement plans (i.e., unless addressed in paragraph 10 of the General Note). In addition, a Canadian retirement compensation arrangement (“RCA”) is not a qualifying retirement plan because it is not considered to be generally exempt from income taxation in Canada. In contrast, contributions to both Roth IRAs and regular IRAs are considered to qualify for favorable treatment under many, but not all, U.S. tax treaties that address cross-border pension contributions, for example, the U.S. Model treaty and the recent U.S. tax treaties with Belgium and the United Kingdom. Under the U.S. tax treaty with Germany, IRAs generally, but not Roth IRAs, qualify for favorable treatment under generally similar cross-border pension contribution rules.

If a plan is not described in paragraph 10 of the General Note, a taxpayer who is a resident of one treaty country may request a determination from the competent authority of the other treaty country that the plan generally corresponds to a pension or retirement plan established in and recognized for tax purposes in that country.⁸¹

Short-term cross-border work assignments

Under the proposed treaty, as under the U.S. Model treaty and several recent U.S. tax treaties, if an individual who is a participant in a qualifying retirement plan in one treaty country (the “home country”) performs personal services in the other country (the “host country”), whether or not the individual is resident in the host country, and certain other requirements are met, contributions made by or on behalf of the individual to the qualifying retirement plan during the period he or she performs such personal services, and benefits accrued under such plan, are deductible or excludible in computing his or her taxable income in the host country. Similarly, contributions made to the plan by or on behalf of his or her employer during such period are allowed as a deduction in computing the employer’s profits in the host country. For example, if a participant in a U.S. qualifying retirement plan goes to work in Canada for a period of time, contributions made by the participant and his or her employer during that period are not included in the participant’s income in Canada, and the employer may deduct its contributions from its business profits in Canada.

The rules of the immediately preceding paragraph apply only if all of the following six conditions apply: (a) the remuneration that the individual receives with respect to the services performed in the host country is taxable in the host country; (b) the individual was participating in the qualifying retirement plan, or in another similar plan for which the plan was substituted, immediately before he or she began performing services in the host country; (c) the individual was not a resident of the host country immediately before the individual began performing the services in the host country; (d) the individual has performed personal services in the host country for the same or related employer for no more than 60 of the 120 months preceding the individual’s taxation year; (e) the contributions and benefits are attributable to services performed by the individual in the host country, and are made or accrued during the period in which the individual performs those services; and (f) the services in a particular tax year to which the contributions and benefits relate may not be taken into account for purposes of determining the individual’s entitlement to benefits under a plan that is (i) a resident of the host country, (ii) generally exempt from income taxation in the host country, and (iii) operated to provide pension or retirement benefits, and no contributions for that period may be made by or on behalf of the individual to such a plan.

In general, the U.S. Model treaty and recent U.S. treaties incorporate condition (b) above, but not the other five conditions. Thus, the proposed protocol provides more restrictive conditions than other U.S. treaties that grant such benefits.

⁸¹ In the case of the United States, such a determination must be requested under Rev. Proc. 2006-54, 2006-49 I.R.B. 655 (or any applicable analogous provision). In the case of Canada, the current version of Information Circular 71-17 provides guidance on obtaining assistance from the Canadian competent authority.

In connection with condition (c), the Technical Explanation states that a citizen of the United States who has been a resident of Canada may be entitled to benefits under these rules if he performs services in the United States for a limited period of time and was a resident of Canada immediately before he began performing such services.

The recent U.S. tax treaty with Belgium also has a time limitation similar to condition (d) above, in that case a cumulative period not exceeding ten calendar years. The rationale for condition (d) is that a host country should not be required to grant these benefits in cases of very long visits to the host country, since the host country is unlikely to be able to tax the distributions.

The Technical Explanation states that the purpose of condition (e) is to prevent individuals who render services in the host country for a very short period of time from making disproportionately large contributions to home country qualifying retirement plans in order to offset the tax liability associated with the income earned in the host country.⁸²

The Technical Explanation provides that the purpose of condition (f) is to prevent double benefits for contributions to both a home country plan and a host country plan with respect to the same services. Thus, for example, an individual who is working temporarily in the United States and making contributions to a qualifying retirement plan in Canada with respect to services performed in the United States may not make contributions to an IRA in the United States with respect to the same services.

The treaty pension benefits for short-term cross-border work assignments under the proposed protocol apply only to the extent that the contributions or benefits would qualify for tax relief in the home country if the individual were a resident of, and performed the services in, that country.⁸³ In contrast, the U.S. Model treaty and the U.S. treaties providing similar benefits to

⁸² The Technical Explanation states that, in the case where the United States is the host country, contributions will be deemed to have been made on the last day of the preceding taxable year if the payment is on account of such taxable year and is treated under U.S. law as a contribution made on the last day of the preceding taxable year.

⁸³ The Technical Explanation states that where the United States is the home country, the amount of contributions that may be excluded from the employee's income under these rules for Canadian purposes is limited to the U.S. dollar amount specified in section 415 or the U.S. dollar amount specified in section 402(g)(1) to the extent contributions are made from the employee's compensation. For this purpose, the dollar limit specified in section 402(g)(1) means the amount applicable under section 402(g)(1) (including the age 50 catch-up amount in section 402(g)(1)(C)) or, if applicable, the parallel dollar limit applicable under section 457(e)(15) plus the age 50 catch-up amount under section 414(v)(2)(B)(i) for a section 457(g) trust.

The Technical Explanation also states that where Canada is the home country, the amount of contributions that may be excluded from the employee's income under these rules for U.S. purposes is subject to the limitations specified in subsections 146(5), 147(8), 147.1(8) and (9), and 147.2(1) and (4) of the Income Tax Act and paragraph 8503(4)(a) of the Income Tax Regulations, as applicable.

short-term cross-border workers provide that the individual may obtain no better treatment in the host country than he would if both he and the plan were residents of the host country.

However, if the host country is the United States and the individual is a citizen of the United States, the benefits granted to the individual also may not exceed the benefits that would be allowed by the United States to its residents for contributions to, or benefits otherwise accrued under, a generally corresponding pension or retirement plan established in and recognized for tax purposes by the United States. Thus, in that case, the lower of the Canadian and the U.S. limits applies. The Technical Explanation states that under this rule, U.S. citizens working temporarily in the United States and participating in a Canadian plan will not receive more favorable U.S. tax treatment than U.S. citizens participating in a U.S. plan.

The pension benefits for short-term work assignments also applies to allow host country deductions for contributions made to the home country plan by an individual's employer, even though such a deduction might not be allowable under the domestic law of the host country. This rule applies whether the employer is a resident of the host country or a permanent establishment that the employer has in the host country, and also applies to contributions by a person related to the individual's employer, such as contributions by a parent corporation for its subsidiary, that are treated under the law of the host country as contributions by the individual's employer. For example, if an individual who is participating in a qualifying retirement plan in Canada performs services for a limited period of time in the United States for a U.S. subsidiary of a Canadian company, a contribution to the Canadian plan by the parent company in Canada that is treated under U.S. law as a contribution by the U.S. subsidiary would be covered by the rule.

The Technical Explanation states that the maximum amount of the allowable deduction is to be determined under the laws of the home country. Thus, where the United States is the home country, the amount of the deduction that is allowable in Canada will be subject to the limitations of section 404 (including the section 401(a)(17) and 415 limitations). Where Canada is the home country, the amount of the deduction that is allowable in the United States is subject to the limitations specified in subsections 147(8), 147.1(8) and (9), and 147.2(1) of the Income Tax Act, as applicable.

Cross-border commuters

The proposed protocol, unlike the U.S. Model treaty and other U.S. treaties, addresses the case of contributions made to, or benefits accrued under, a qualifying retirement plan in a treaty country by or on behalf of an individual who performs services as an employee in that treaty country (the "services country") but who is a resident of the other treaty country (the "residence country"). Under this special "commuter" provision, if certain requirements are satisfied, such contributions or benefits are deductible or excludible in computing the individual's income in the residence country. The provision does not address employer deductions because the employer is located in the services country and is, therefore, generally eligible for deductions under that country's domestic law.

For the commuter provision to apply, the remuneration for the services must be taxable in services country and must be borne either by an employer who is a resident of the services

country or by a permanent establishment that the employer has in the services country. The contributions and benefits must be attributable to those services and must be made or accrued during the period in which the individual performs those services.⁸⁴ The benefits granted in the residence country under the commuter provision are available only to the extent that the contributions or benefits qualify for tax relief in the services country.⁸⁵

In addition, benefits granted by the residence country under the commuter provision are limited to the amount of certain benefits that would be allowable under the domestic law of the residence country. Where the United States is the residence country, the benefits may not exceed the benefits that would be allowed by the United States to its residents for contributions to, or benefits otherwise accrued under, a generally corresponding pension or retirement plan established in and recognized for tax purposes by the United States. Consequently, for purposes of determining an individual's eligibility to participate in and receive tax benefits with respect to a pension or retirement plan or other retirement arrangement in the United States, contributions made to, or benefits accrued under, a qualifying retirement plan in Canada by or on behalf of the individual are treated as contributions or benefits under a generally corresponding pension or retirement plan established in, and recognized for tax purposes by, the United States. The purpose of this rule is to ensure that U.S. residents working in Canada and participating in a qualifying retirement plan there are not treated any better for U.S. tax purposes than they would be treated if they were working in the U.S. and participating in a U.S. plan. The Technical Explanation provides an example under which a qualifying retirement plan in Canada is taken into account for purposes of determining whether the individual is an "active participant" in a plan within the meaning of section 219(g)(5), with the result that the individual's ability to make deductible contributions to a U.S. IRA is limited.⁸⁶

⁸⁴ As in the case of the short-term work assignment provision, where the United States is the residence country, contributions will be deemed to have been made on the last day of the preceding taxable year if the payment is on account of such taxable year and is treated under U.S. law as a contribution made on the last day of the preceding taxable year.

⁸⁵ Where the United States is the services country, the amount of contributions that may be excluded under this rule is the U.S. dollar amount specified in section 415 or the U.S. dollar amount specified in section 402(g)(1) (as defined above) to the extent contributions are made from the employee's compensation. Where Canada is the services country, the amount of contributions that may be excluded from the employee's income under this rule is subject to the limitations specified in subsections 146(5), 147(8), 147.1(8) and (9), and 147.2(1) and (4) of the Income Tax Act and paragraph 8503(4)(a) of the Income Tax Regulations, as applicable.

⁸⁶ According to the Technical Explanation, where Canada is the residence country, the amount of contributions otherwise allowable as a deduction under the commuter provision may not exceed the individual's deduction limit for contributions to RRSPs remaining after taking into account the amount of contributions to RRSPs deducted by the individual under the law of Canada for the year. The amount deducted by the individual under the commuter provision is taken into account in computing the individual's deduction limit for subsequent taxation years for contributions to RRSPs.

U.S. citizens resident in Canada

The proposed protocol provides rules applicable to certain U.S. citizens who are residents of Canada. These rules are similar to those in the U.S. Model treaty and other recent U.S. treaties. Under these rules, a U.S. citizen who is resident in Canada may exclude or deduct for U.S. tax purposes contributions to a qualifying retirement plan in Canada, provided such contributions are made during the period (or are attributable to the period) the U.S. citizen exercises taxable employment in Canada and are attributable to such employment, and expenses related to such employment are borne by a Canadian employer or Canadian permanent establishment. Contributions will be deemed to have been made on the last day of the preceding taxable year if the payment is on account of such taxable year and is treated under U.S. law as a contribution made on the last day of the preceding taxable year. Similarly, employer contributions to, or benefits accrued under, a Canadian qualifying retirement plan are not treated as part of the employee's taxable income in the United States.

The U.S. tax benefits under the rules of the immediately preceding paragraph are limited to the lesser of: (1) the amount of tax relief allowed for the contributions or benefits in Canada, and (2) the amount of tax relief that would be allowed by the United States to its residents for contributions to, and benefits accrued under, a generally corresponding pension plan established in the United States. The intent of these rules is that a U.S. citizen living and working in Canada will not receive better U.S. treatment under this provision than a U.S. citizen living and working in the United States. According to the Technical Explanation, the amount of contributions that may be excluded from the employee's income under these rules is the U.S. dollar amount specified in section 415 or the U.S. dollar amount specified in section 402(g)(1) to the extent contributions are made from the employee's compensation. In addition, according to the Technical Explanation, pursuant to section 911(d)(6), an individual may not claim benefits under this provision with respect to services the remuneration for which is excluded from the individual's gross income under section 911(a).

Further, contributions made to (and benefits accrued under) a Canadian qualifying retirement plan are counted as if such contribution were made, and benefits were accrued, under a generally corresponding pension or retirement plan established in, and recognized for tax purposes by, the United States when determining the individual's eligibility for benefits and contribution limits with respect to a U.S. pension or retirement plan or other retirement arrangement. Thus, according to the Technical Explanation, the qualifying retirement plan in Canada would be taken into account for purposes of determining whether the individual is an "active participant" within the meaning of section 219(g)(5), with the result that the individual's ability to make deductible contributions to an IRA in the United States would be limited.

Source rule

The proposed protocol also includes a special rule that provides that a distribution from a pension or retirement plan that is reasonably attributable to a contribution or benefit for which a benefit was allowed pursuant to one of the cross-border pension contribution provisions will be deemed to arise in the treaty country in which the plan is established. This rule is intended to ensure that the treaty country in which the plan is established will have the right to tax the gross amount of the distribution under the source country taxation rules of the present treaty, even if a

portion of the services to which the distribution relates were not performed in such treaty country.

Partnerships

The proposed protocol provides that the cross-border pension contribution provisions apply, with such modifications as the circumstances require, as though the relationship between a partnership that carries on a business and an individual partner were that of employer and employee. Thus, according to the Technical Explanation, although the benefits of these provisions are not available with respect to retirement plans for self-employed individuals (who may be deemed under U.S. law to be employees for certain pension purposes), partners participating in a plan established by their partnership may be eligible for those benefits.

Cross-border pension contribution provisions are not subject to the saving clause

The cross-border pension contribution provisions are not subject to the saving clause of paragraph 2 of Article XXIX of the treaty (Miscellaneous Rules), as modified by the proposed protocol, by reason of the exception in subparagraph 3(a) of Article XXIX. Thus, the benefits of these provisions are preserved in the case of U.S. citizens or residents.

Proposed protocol limitations on internal law and modifications to the present treaty with respect to source of payments under life insurance and annuity contracts

The proposed protocol restates the definition of annuity in the present treaty, and adds a source rule to address the treatment of certain payments by branches of insurance companies.

Under new subparagraph 4(b) of Article XVIII of the treaty, an annuity or other amount paid in respect of a life insurance or annuity contract (including a withdrawal in respect of the cash value thereof), will generally be deemed to arise in the treaty country where the person paying the annuity or other amount is resident. However, if the payor, whether a resident of a treaty country or not, has a permanent establishment in a treaty country other than the treaty country in which the payer is a resident, the payment will be deemed to arise in the treaty country in which the permanent establishment is situated if both of the following requirements are satisfied: (1) the obligation giving rise to the annuity or other amount must have been incurred in connection with the permanent establishment, and (2) the annuity or other amount must be borne by the permanent establishment. In cases in which these requirements are satisfied, payments by a Canadian branch of a U.S. insurance company will be deemed to arise in Canada and, therefore, will not be subject to U.S. withholding tax if paid to a person entitled to benefits under the treaty, as modified by the proposed protocol.

Article 14. Government Service

Article XIX (Government Service) of the treaty contains rules applicable to services provided by a citizen of a treaty country to that country. The proposed protocol makes two conforming changes to Article XIX of the treaty. First, it replaces references to “Article XIV (Independent Services)” with references to “Article VII (Business Profits)” to reflect the relocation of the provisions addressing independent services from Article XIV to Article VII of the treaty. Second, it replaces references to “Article XV (Dependent Personal Services)” with

references to “Article XV (Income from Employment)” to reflect that the protocol changes the title of Article XV.

Article 15. Students

The proposed protocol replaces the current treaty’s article pertaining to students. The treatment provided to students, apprentices, and business trainees under the proposed protocol generally corresponds to the treatment provided under the current treaty and the OECD Model treaty, and is similar to the provision in the U.S. Model treaty.

Under the proposed protocol, a student, apprentice, or business trainee who visits a treaty country (“host country”) and who is, or was immediately prior to visiting the host country, a resident of the other treaty country will be exempt from income tax in the host country on certain payments received if the purpose of the visit is to engage in full-time training or full-time education. The exempt payments are limited to those payments the individual may receive for his or her maintenance, education, or training as long as such payments are from sources outside the host country. In the case of apprentices and business trainees, the exemption from income tax in the host country applies only for a period of one year from the time the visitor first arrives in the host country for training.

Article 16. Exempt Organizations

Article 16 of the proposed protocol modifies Article XXI (Exempt Organizations) of the present treaty through deletions, replacements, and renumbering.

In the present treaty, paragraph 2 is comprised of two subparagraphs, 2(a) and 2(b). In the proposed protocol, subparagraph 2(a) is relabeled as new paragraph 2, and no other substantive changes are made. Similarly, subparagraph 2(b) is relabeled as new paragraph 3 and expanded in the proposed protocol.

Under the present treaty, certain types of exempt organizations (for example, pensions) may invest either directly or indirectly with other organizations of the same type, while other types of exempt organizations (for example, charities) are limited to direct investments. Thus, charitable type organizations—which are limited to direct investments—cannot participate in collective investment vehicles. This has the corresponding impact of prohibiting charitable-type organizations from pooling their investments with pensions that are investing indirectly through collective investment vehicles. New paragraph 3 eliminates this restriction by permitting charitable-type organizations to pool their investments with other exempt organizations. Thus, once the proposed protocol enters into force, charitable type organizations will be able to invest indirectly; this will have the corresponding impact of permitting them to pool their investments with pension-type organizations that are also investing indirectly.

As part of the renumbering of the paragraphs, former paragraph 3 is relabeled as paragraph 4. Although the text is identical, the Technical Explanation makes the interesting—but unexplained—observation that the term “related person” is not necessarily the same as the definition provided by paragraph 2 of Article IX (Related Persons). This language was picked up directly from the Technical Explanation of the 1980 treaty and the 1983 and 1984 protocols, and has never been the subject of any administrative guidance.

Article 17. Other Income

Article XXII (Other Income) of the treaty assigns taxing jurisdiction to income not dealt with in other articles of the treaty, including income arising in a third country. In general, the residence state has the exclusive right to tax such income, unless the income arises in the other treaty country, in which case the other treaty country may also tax the income.

The proposed protocol adds a new paragraph to Article XXII for guarantee fees. The new paragraph provides that compensation derived by a resident of a treaty country in respect of a guarantee of indebtedness shall be taxable only in that country, unless the compensation is business profits attributable to a permanent establishment in the other treaty country, in which case Article VII (Business Profits) shall apply.

The new paragraph was necessary to conform the treatment of guarantee fees by the United States and Canada. Absent the new paragraph, the United States would have been permitted to tax guarantee fees paid to a Canadian resident under Article XXII while Canada, which treats guarantee fees as interest, would have been obligated to provide relief from Canadian tax on payments made to U.S. residents under Article XI (Interest).

Article 18. Capital

The proposed protocol modifies paragraph 2 of Article XXIII (Capital) of the present treaty, consistent with the deletion of the Article XIV (Independent Personal Services) by Article 9 of the proposed protocol. Under the present treaty, capital represented by personal property forming part of the business property of a permanent establishment which a resident of a treaty country has in the other treaty country, or by personal property pertaining to a fixed base available to a resident of a treaty country in the other treaty country for the purpose of performing independent personal services, may be taxed in that other country. The proposed protocol deletes references to independent personal services and a fixed base because, under the proposed protocol, the income from independent personal services is treated as business profits subject to Articles V (Permanent Establishment) and VII (Business Profits) of the treaty.

Article 19. Elimination of Double Taxation

Article XIV (Elimination of Double Taxation) of the treaty contains rules for the elimination of double taxation. The proposed protocol replaces subparagraph 2(b) of Article XIV with a new subparagraph 2(b), changing the obligations of Canada with respect to dividends received by a Canadian company from a U.S.-resident company.

New subparagraph 2(b) allows a Canadian company receiving a dividend from a U.S.-resident company of which it owns at least 10 percent of the voting stock, a credit against Canadian income tax of the appropriate amount of income tax paid or accrued to the United States by the dividend paying company with respect to the profits out of which the dividends are paid. Prior subparagraph 2(b) allowed a Canadian company to deduct in computing its Canadian taxable income any dividend received by it out of the exempt surplus of a foreign affiliate that is a resident of the United States. According to the Technical Explanation, the change is consistent with current Canadian tax treaty practice: it does not indicate any present intention to change Canada's "exempt surplus" rules, and those rules remain in effect.

Article 20. Non-Discrimination

The proposed protocol revises the general rules of the nondiscrimination article of the existing treaty to bring those rules into closer conformity with the U.S. Model treaty.

Under the proposed protocol, neither treaty country is permitted to discriminate against nationals of the other country by imposing on those nationals more burdensome taxation or any related requirement than it imposes or may impose on its own nationals in the same circumstances.

The term “national” of a treaty country is defined in Article III (General Definitions) of the existing treaty, as modified by the proposed protocol, as any individual possessing the citizenship or nationality of that country and any legal person, partnership, or association deriving its status from the laws of that country. The Technical Explanation notes that a national is afforded protection by the prohibition against discriminatory taxation even if the national is a resident of neither the United States nor Canada. A U.S. citizen who is a resident of a third country, therefore, is entitled to the same treatment by Canada as a Canadian national who is resident in a third country.

The nondiscrimination rule requires similar treatment only of persons in the same circumstances, and whether a treaty country taxes persons on worldwide income is considered a significant circumstance. Thus, according to the Technical Explanation, the United States is not required to apply the same tax rules to a national of Canada who is not a U.S. resident as it applies to a U.S. national who also is not a U.S. resident. A U.S. nonresident citizen is subject to U.S. tax on the individual’s worldwide income and therefore is not treated as in the same circumstances as a Canadian citizen who is not a U.S. resident. Consequently, according to the Technical Explanation, the nondiscrimination rule does not require the United States to permit a Canadian national who is a third-country resident to be taxed at graduated rates on U.S.-source investment income even though a U.S. citizen resident in that third country would be taxed at graduated rates.

Because the new nondiscrimination rule of the proposed protocol applies to nationals of treaty countries who are residents of third countries, the protocol deletes as redundant a rule in the existing treaty that specifically governs the treatment of third-country residents.

The proposed protocol also makes clerical and conforming changes to the existing nondiscrimination article.

Article 21. Mutual Agreement Procedure

Like other U.S. income tax treaties, the existing treaty includes provisions that allow taxpayers to bring to the attention of the competent authorities problems under the treaty and that authorize the competent authorities of the two countries to cooperate to resolve disputes, clarify issues, and address cases of double taxation not provided for in the treaty. Under these provisions, collectively referred to as the mutual agreement procedure (“MAP”), a case that the competent authorities are unable to resolve may be submitted to arbitration if the competent authorities and the affected taxpayer agree to arbitration. The proposed protocol replaces this optional arbitration provision with rules for mandatory binding arbitration for certain cases about

which the competent authorities cannot reach a negotiated agreement. The notes to the proposed protocol include additional rules and procedures governing the mandatory binding arbitration.

In general, the proposed protocol provides that a case will be resolved through arbitration if under the MAP the competent authorities have tried but are unable to reach a complete agreement in a case and if three additional conditions are satisfied.

First, tax returns must have been filed with at least one of the treaty countries for the taxable years at issue in the case.

Second, the case (1) must involve the application of one or more articles of the treaty that the competent authorities have agreed in an exchange of notes will be the subject of arbitration and (2) must not be one that the competent authorities agree, before the date on which arbitration proceedings otherwise would have begun, is not suitable for determination by arbitration. Alternatively, the competent authorities may agree that a particular case is suitable for determination by arbitration. In the notes, the United States and Canada have agreed that a case may be resolved through arbitration if it involves the application of one or more of the following articles of the treaty (and is not a particular case that the competent authorities agree is not suitable for determination by arbitration): Article IV (Residence), but only to the extent the case relates to the residence of natural persons; Article V (Permanent Establishment); Article VII (Business Profits); Article IX (Related Persons), and Article XII (Royalties), but only to the extent the case relates (1) to the application of Article XII to transactions involving related persons or (2) to an allocation of amounts between taxable and non-taxable royalties.

Third, all concerned persons and their authorized representatives or agents must agree (in a “confidentiality agreement”) before the arbitration proceedings not to disclose to any other person any information, other than the determination of the arbitration board, received during the course of the arbitration proceeding from either treaty country or the arbitration board. The Technical Explanation states that the confidentiality agreement may be executed by any concerned person that has legal authority to bind any other concerned person. For example, according to the Technical Explanation, a parent corporation with the legal authority to bind its subsidiary to keeping information confidential may execute a confidentiality agreement for itself and its subsidiary. The term “concerned person” means both the person that has presented a case to a competent authority for consideration under the MAP and all other persons whose tax liability to either treaty country may be directly affected by a mutual agreement arising from that consideration.

The notes include confidentiality rules for arbitration board members and staff and for the competent authorities. Those individuals may not disclose information relating to an arbitration proceeding (including the board’s determination) unless disclosure is permitted by the treaty and the domestic laws of the United States and Canada. According to the notes, all material prepared in the course of or relating to an arbitration proceeding will be considered information exchanged between treaty countries. The United States and Canada must ensure that all members of the arbitration board and their staffs, before acting in an arbitration proceeding, sign and send to each country notarized statements in which they agree to abide by and be subject to the confidentiality and nondisclosure requirements of the treaty’s exchange of information and MAP

articles and the applicable domestic laws of each country. If provisions conflict, the most restrictive provision applies.

The notes provide that an arbitration board's determination is limited to a conclusion about the amount of income, expense, or tax reportable to the treaty countries.

Under the notes, even after an arbitration proceeding has been initiated, the competent authorities may agree to resolve a case and terminate the proceeding, and a concerned person may withdraw a request that the competent authorities engage in the MAP (and thereby terminate an arbitration proceeding) at any time.

The proposed protocol provides that arbitration proceedings in a case will begin on the later of (1) two years after the commencement date of that case unless both competent authorities previously have agreed to a different date, or (2) the earliest date on which both competent authorities have received from all concerned persons the confidentiality agreements described above. The commencement date of a case is the earliest date on which both competent authorities have received the information necessary to undertake substantive consideration for a mutual agreement.

The notes provide two sets of details related to the rules just described for when an arbitration proceeding will begin. First, the confidentiality agreement must be a notarized statement agreeing that the concerned person and each person acting on behalf of the concerned person will not disclose to any other person any information received during the course of the arbitration proceeding from either treaty country or the arbitration board other than the board's determination. Second, the notes state that each competent authority must confirm in writing to the other competent authority and to the concerned person or persons the date on which it received the information necessary to undertake substantive consideration for a mutual agreement. In the United States, the required information is described in Revenue Procedure 2006-54, section 4.05 (or any applicable analogous provisions) and, for cases initially submitted as a request for an Advance Pricing Agreement, in Revenue Procedure 2006-9, section 4 (or any applicable analogous provisions). In Canada, the required information is described in Information Circular 71-17 (or any applicable successor publication). The notes, though, provide that the necessary information will not be considered to have been received until both competent authorities have received copies of all materials submitted to either treaty country by the concerned person or persons in connection with the MAP.

Under the notes, each treaty country has 60 days from the date on which an arbitration proceeding begins to send a written communication to the other treaty country appointing one member of the arbitration board. Within 60 days of the date on which the second such communication is sent, the two members appointed by the treaty countries must appoint a third member, and that member will serve as chair of the board. If either treaty country fails to appoint a member, or if the members appointed by the treaty countries fail to agree to a third member, a treaty country must ask the highest ranking member of the Secretariat at the Centre for Tax Policy and Administration of the Organisation for Economic Co-operation and Development who is not a citizen of either the United States or Canada to appoint the remaining member or members by written notice to both the United States and Canada within 60 days of the date of the failure. The competent authorities are directed to develop a non-exclusive list of

individuals with familiarity in international tax matters who may serve as the chair of the board. The notes provide that the arbitration board may adopt any procedures necessary for the conduct of its business so long as the procedures are not inconsistent with any other provisions of the MAP or the notes.

Under the notes, each treaty country is permitted to submit within 60 days of the appointment of the chair of the arbitration board a proposed resolution of the case and a supporting position paper. The proposed resolution will describe the proposed disposition of the specific amounts of income, expense, or taxation at issue in the case. The arbitration board will provide copies of each treaty country's proposed resolution and supporting position to the other treaty country on the date on which the board receives the latter of the submissions. If only one treaty country submits a proposed resolution to the board within the 60-day time period, that proposed resolution is deemed to be the board's determination, and the proceeding will be terminated. Each treaty country is permitted to submit a reply submission to the board within 120 days of the appointment of the board chair. The arbitration board may request additional information, but the treaty countries are not otherwise permitted to submit additional information. If the arbitration board asks a treaty country for additional information, the board must provide to the other treaty country a copy of its request and a copy of the response it receives and must do so on the days on which the request is made and the response is received. Except in relation to limited logistical matters, the treaty countries may communicate with the arbitration board only through written communications between the competent authorities and the chair of the board.

The notes provide that the arbitration board must deliver a determination in writing to the treaty countries within six months of the appointment of the chair. In making its determination, the board must, according to the notes, apply as necessary the following legal authorities: (1) the provisions of the treaty; (2) any agreed treaty commentaries or explanations of the treaty countries concerning the treaty; (3) the laws of The United States and Canada to the extent they are not inconsistent with each other; and (4) any OECD Commentary, Guidelines, or Reports regarding relevant analogous portions of the OECD Model Tax Convention.

The proposed protocol provides that unless a concerned person does not accept the determination of an arbitration board, the determination will constitute a resolution by mutual agreement and will be binding on both treaty countries. The notes provide that the determination will not state a rationale and will have no precedential value. Under the notes, each concerned person must, within 30 days of receiving the board's determination from the competent authority to which the case was first presented, advise that competent authority whether that concerned person accepts the determination. If a concerned person fails to advise the relevant competent authority within the 30-day period, the determination will be considered not to have been accepted, and the case may not later be a subject of arbitration.

The members of the arbitration board and their staffs are considered persons or authorities to whom information may be exchanged under Article XXVII (Exchange of Information) of the existing treaty.

The notes provide several additional rules related to the operation of an arbitration proceeding. An arbitration board in a particular case will meet in facilities provided by the treaty

country whose competent authority initiated the MAP in that case. The treatment of interest and penalties associated with an arbitration case will be determined by applicable domestic law of the relevant treaty country or countries. The arbitration board members' fees and expenses will be set in accordance with the International Centre for Settlement of Investment Disputes ("ICSID") Schedule of Fees for arbitrators, as in effect on the date on which the arbitration proceedings begin. Those fees and expenses, and any fees for language translation, will be borne equally by the United States and Canada. The treaty country whose competent authority initiated a MAP in a particular case will provide, at its own cost, meeting facilities, related resources, financial management, other logistical support, and general administrative coordination of the proceeding.

The competent authorities of the treaty countries may modify or supplement the rules and procedures provided in the notes to the extent necessary to better implement the intent of mandatory arbitration to eliminate double taxation.

Article 22. Assistance in Collection

The assistance-in-collection articles of income tax treaties generally provide rules governing the treaty countries' assistance of one another in collecting taxes. In general, under the existing treaty, the United States and Canada have undertaken to lend assistance to each other in the collection of all taxes, together with interest, costs, additions to taxes and civil penalties. The treaty, however, provides limitations on this assistance. One such limitation is that no assistance will be provided for a revenue claim in respect of an individual if the individual demonstrates that the revenue claim relates to a taxable period in which the individual was a citizen of the requested treaty country.

The proposed protocol amends this limitation. Under the proposed protocol, no assistance will be provided for a revenue claim in respect of an individual if the individual demonstrates that the revenue claim relates either to (1) (as under the existing treaty) a taxable period in which the individual was a citizen of the requested treaty country, or to (2) a taxable period that ended before November 9, 1995, but only if the taxpayer became a citizen of the requested treaty country before November 9, 1995 and remains a citizen of that country at the time the other country applies for collection of a claim. According to the Technical Explanation, the additional language is "intended to avoid the potentially discriminating application of [the former rule] as applied to persons who were not citizens of the requested State in the taxable period to which a particular collection request related, but who became citizens of the requested State at a time prior to the entry into force of [the assistance in collection article] as set forth in the third protocol signed March 17, 1995." Article 27 of the proposed protocol, described below, provides that this change will apply to revenue claims finally determined after November 9, 1985, the effective date of the adoption of the assistance of collection provision in the third protocol to the existing treaty.

The existing assistance on collection provisions apply to all categories of taxes collected by or on behalf of a government of a treaty country. The proposed protocol amends this rule so that the assistance on collection provisions also explicitly apply to contributions to social security and employment insurance premiums levied by or on behalf of the government of a treaty country. The Technical Explanation states that the language in the existing treaty does not

cover Canada's social security and employment insurance programs because the contributions to those programs are not considered taxes under Canadian law.

Article 23. Exchange of Information

The proposed protocol replaces the exchange of information article of the existing treaty with a new article. The new article is broadly similar to the information exchange rules in the U.S. Model treaty.

The exchange of information provisions generally provide that the two competent authorities will exchange such information as may be relevant in carrying out the provisions of the treaty or in carrying out the provisions of the domestic laws of the United States and Canada concerning taxes to which the treaty applies to the extent the taxation under those laws is not contrary to the treaty.

For purposes of applying the information exchange rules, the treaty is considered to apply not just to taxes specified in Article II (Taxes Covered) of the treaty but (1) to all taxes imposed by the United States or Canada and (2) to other taxes to which any other provision of the treaty applies, but only to the extent that the information that would be exchanged may be relevant in applying that provision. The Technical Explanation states that this rule is intended to ensure that information exchange extends to taxes of every kind at the national level in the United States and Canada. Information exchange does not, though, apply to state, provincial, or local taxes.

The Technical Explanation notes that in describing information that may be exchanged, the proposed protocol changes the existing treaty's phrase "is relevant" to "may be relevant" to clarify that the information exchange rules incorporate the standard in Code section 7602. This standard authorizes the IRS to examine data that "may be relevant or material," meaning data of potential relevance regardless of whether it would be admissible in court. The Technical Explanation states that the "may be relevant" standard does not permit a treaty country to request information about all bank accounts maintained by its residents in the other treaty country or about all bank accounts maintained by its residents with a particular bank.

Exchange of information is not restricted by Article I (Personal Scope). Accordingly, information may about persons who are residents of neither Canada nor the United States may be requested and provided under this article.

Any information exchanged under the proposed protocol must be treated as secret in the same manner as information obtained under the domestic laws of the treaty country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the administration and enforcement in respect of, or the determination of appeals in relation to the taxes to which the treaty applies. According to the Technical Explanation, the U.S. competent authority is permitted to allow legislative bodies such as the tax-writing committees of Congress and the Government Accountability Office to examine tax return information received from Canada when those bodies or offices are overseeing or studying the administration of U.S. tax laws. The persons or authorities receiving information may use the information only for the assessment, collection, administration, enforcement, and appeals purposes described above. The

competent authorities may, according to the Technical Explanation, request and provide information for cases under examination or criminal investigation, in collection, on appeals, or under prosecution. Exchanged information may be disclosed in public court proceedings or in judicial decisions.

Information exchanged under this article may be disclosed to two additional groups. First, a treaty country may disclose information received from the other treaty country to its political subdivisions and local authorities if the information relates to taxes imposed by those subdivisions or local authorities that are substantially similar to national taxes covered by the treaty. According to the Technical Explanation, however, this rule does not authorize a treaty country to request information on behalf of a state, province, or local authority. Second, the competent authorities may disclose to an arbitration board established under the mutual agreement procedures set forth in Article XXVI of the treaty such information as is necessary for carrying out the arbitration. Information provided to a political subdivision or local authority or to an arbitration panel is subject to the same use and disclosure requirements as is information received by the treaty country governments.

If information is requested by a treaty country in accordance with this article, the proposed protocol provides that the requested treaty country must use its information gathering measures to obtain the requested information even if that country may not need the information for its own tax purposes. According to the Technical Explanation, this rule clarifies that the limitations on information exchange described next do not prevent a treaty country from requesting information from a bank or a fiduciary that the treaty country does not need for its own tax purposes.

As is true under the U.S. and OECD Model treaties, under the proposed protocol a country is not required to carry out administrative measures at variance with the laws and administrative practice of either treaty country; to supply information that is not obtainable under the laws or in the normal administrative practice of either treaty country; or to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy. The Technical Explanation notes, however, that if a treaty country is asked to provide information, it should provide the information even if its own statute of limitations period has expired for the issue to which the information relates. According to the Technical Explanation, the statute of limitations of the treaty country making the request should govern. The Technical Explanation also states that even if the limitations on information exchange mean that a treaty country is not obligated to supply information in response to a request from the other treaty country, the requested country may choose to supply the information if doing so does not violate its internal law.

A treaty country may not construe the limitations on information exchange described above to permit the country to decline to supply information because the information is held by a bank, another financial institution, a nominee or a person acting in an agency or fiduciary capacity, or because the information relates to ownership interests in a person. According to the Technical Explanation, a treaty country may not argue that its domestic bank secrecy laws or other similar laws allow it not to exchange information that otherwise is required to be exchanged.

The proposed protocol provides that if specifically requested by the competent authority of a treaty country, the competent authority of the other treaty country must provide information under this article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings). The intent of this provision, according to the Technical Explanation, is to ensure that information may be introduced as evidence in the judicial proceedings of the requesting country.

The proposed protocol lacks a provision included in the U.S. Model treaty requiring each treaty country to endeavor to collect on behalf of the other treaty country such amounts as may be necessary to ensure that treaty relief from taxation otherwise imposed by the other treaty does not inure to the benefit of persons not entitled to relief. This rule is intended to address cases in which, for instance, a resident of a treaty country receives from sources in the other treaty country investment income as a nominee for a third-country resident.

Like the U.S. Model treaty, the proposed protocol provides that a treaty country that receives a request to exchange information must allow representatives of the requesting country to enter the requested state to interview individuals and examine books and records with the consent of the persons subject to examination.

The notes to the proposed protocol state that the United States and Canada understand that the standards and practices described in the exchange of information rules are to be no less effective than those described in the Model Agreement on Exchange of Information on Tax Matters developed by the OECD Global Forum Working Group on Effective Exchange of Information.

Article 24. Miscellaneous Rules

Article XXIX (Miscellaneous Rules) of the treaty contains miscellaneous rules, including the “saving clause” in paragraph 2 of Article XXIX. The saving clause provides generally that the United States and Canada may each tax its residents and, in the case of the United States, its citizens and certain former citizens (for a period of 10 years) as if there were no treaty in effect.

The proposed protocol amends the saving clause to bring the treaty generally in conformity with the U.S. taxation of former citizens and former long-term residents under section 877 of the Code. The treaty replaces existing paragraph 2 with subparagraphs 2(a) and 2(b). Subparagraph 2(a) contains language that generally corresponds to former paragraph 2, but omits certain language pertaining to former citizens, which are addressed in new subparagraph 2(b).

Similar to subparagraph 2(a), new subparagraph 2(b) operates as a “saving clause” and provides that notwithstanding the other provisions of the treaty, a former citizen or former long-term resident of the United States, may, for a period of 10 years following the loss of such status, be taxed in accordance with the laws of the United States with respect to U.S.-source income (including income deemed under the domestic law of the United States to arise from U.S. sources).

Paragraphs 11 and 12 of the General Note provide definitions based on Code section 877 that are relevant to the application of paragraph 2(b) of Article XXIX. Paragraph 11 defines the

term “long-term resident” as any individual who is a lawful permanent resident of the United States in eight or more taxable years during the preceding 15 taxable years. It further provides that an individual is not treated as a lawful permanent resident for any taxable year in which the individual is treated as a resident of Canada under the proposed treaty, or as a resident of any country other than the United States under the provisions of any other tax treaty of the United States, and, in either case, the individual does not waive the benefits of the relevant treaty.

Paragraph 12 explains that the phrase “income deemed under the domestic law of the United States to arise from such sources” includes gains from the sale or exchange of stock of a U.S. company or debt obligations of a U.S. person, the United States, a State, or a political subdivision thereof, or the District of Columbia, gains from property (other than stock or debt obligations) located in the United States, and, in certain cases, income or gain derived from the sale of stock of a non-U.S. company or a disposition of property contributed to such non-U.S. company where such company would be a controlled foreign corporation with respect to the individual if such person had continued to be a U.S. person. In addition, an individual who exchanges property that gives rise or would give rise to U.S.-source income for property that gives rise to foreign-source income will be treated as if he had sold the property that would give rise to U.S.-source income for its fair market value, and any consequent gain shall be deemed to be income from sources within the United States.

The proposed protocol departs from Code section 877 in one respect. Under section 877, a former citizen or former long-term resident is subject to U.S. tax (for a period of 10 years) on both the individual’s U.S.-source income (including deemed U.S.-source income), and the individual’s foreign-source income that is effectively connected with the conduct of a trade or business within the United States. However, new subparagraph 2(b) is limited to U.S.-source income (and deemed U.S.-source income). The Canadian protocol differs from the saving clause in the U.S. Model treaty, which permits the United States to tax both U.S.-source and effectively connected foreign-source income. As a practical matter, this difference may be of little significance in most cases.

For any individual who relinquishes U.S. citizenship or ceases to be a lawful permanent resident of the United States (“expatriates”) on or after June 17, 2008, the Heroes Earnings Assistance and Relief Tax Act of 2008,⁸⁷ replaces section 877 with a new set of special rules. In general, to the extent those rules impose U.S. tax on an individual after the individual expatriates, they require or deem the individual to waive any rights to claim a reduction in U.S. tax under a U.S. tax treaty and any other rights under a U.S. tax treaty that would preclude the assessment or collection of tax imposed by the new rules. However, new subparagraph 2(b) will continue to be relevant for individuals who relinquished U.S. citizenship or ceased to be a lawful permanent resident of the United States prior to June 17, 2008.

⁸⁷ Pub. L. No. 110-245, sec. 301 (June 17, 2008).

Article 25. Limitation on Benefits

In general

The proposed protocol replaces the rules of Article XXIX A (Limitation on Benefits) of the present treaty with rules that are similar to the limitation-on-benefits provisions included in recent U.S. income tax treaties. The rules in the present treaty are not reciprocal and may be applied only by the United States. The new rules are reciprocal and are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in Canada or the United States.

The treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Canada as they apply to residents of the two countries. At times, however, residents of third countries attempt to benefit from a treaty by engaging in treaty shopping. Treaty shopping by a third-country resident may involve organizing in a treaty country a corporation that is entitled to the benefits of the treaty. Alternatively, a third-country resident eligible for favorable treatment under the tax rules of its country of residency may attempt to reduce the income base of a treaty country resident by having that treaty country resident pay to it, directly or indirectly, interest, royalties, or other amounts that are deductible in the treaty country from which the payments are made. Limitation-on-benefits provisions are intended to deny treaty benefits in certain cases of treaty shopping or income stripping engaged in by third-country residents.

Generally, under the proposed protocol, a resident of either treaty country is entitled to all the benefits accorded by the treaty if the resident is a qualifying person. A qualifying person is a resident that is (1) a natural person; (2) one of the two treaty countries or a political subdivision or local authority of one of the two countries; (3) a company or trust that satisfies a publicly traded test or that is a subsidiary of a public company; (4) a company or trust that satisfies an ownership test and a base erosion test; (5) an estate; (6) a not-for-profit organization that satisfies a beneficiaries test; (7) an organization established to provide pension or employee benefits that satisfies a beneficiaries test; or (8) an organization established to earn income for persons described in either (6) or (7). A resident that is not a qualifying person may be entitled to treaty benefits with respect to certain items of income under the derivative benefits test or the active business test.

A person that does not satisfy any of the requirements described above may be entitled to the benefits of the treaty if the source country's competent authority so determines.

Qualifying persons eligible for all treaty benefits

Natural person

Under the proposed protocol, a natural person resident in the United States or Canada is entitled to all treaty benefits. If, however, such a natural person receives income as a nominee on behalf of a third-country resident, and thus is not the beneficial owner of the income, benefits may be denied.

Governments

The proposed protocol provides that the United States and Canada, and any political subdivision or local authority of either of the two countries, are entitled to all treaty benefits.

Publicly traded entities and subsidiaries

A company or trust that is a resident of the United States or Canada is entitled to all treaty benefits if the principal class of its shares or units (and any disproportionate class of shares or units) is primarily and regularly traded on one or more recognized stock exchanges (the “primarily and regularly traded test”). Certain key elements of this test are described below.

The term “principal class of shares” means the ordinary or common shares of a company representing the majority of the aggregate voting power and value of that company. If the company does not have a single class of ordinary or common shares representing the majority of the aggregate voting power and value, then the “principal class of shares” means that class or those classes of shares that in the aggregate represent a majority of the aggregate voting power and value of the company.

A company that is resident in one treaty country has a “disproportionate class of shares” if any outstanding class of shares is subject to terms or other arrangements that entitle a shareholder to a larger portion of the company’s income, profit, or gain in the other treaty country than that to which the shareholder would be entitled in the absence of those terms or arrangements. For example, a company resident in Canada meets this test if it has outstanding a class of tracking stock that pays dividends based upon a formula that approximates the company’s return on its assets employed in the United States. Similar principles apply to determine whether there are disproportionate interests in a trust.

The term “primarily traded” is not defined in the proposed protocol and therefore has the meaning it has under the laws of the relevant treaty country, usually the source country. In the United States, the term has the same meaning as it does under Treas. Reg. section 1.884-5(d)(3). Based on that provision, the Technical Explanation states that stock of a corporation is primarily traded if the number of shares in the company’s principal class of shares that are traded during the taxable year on all recognized stock exchanges exceeds the number of shares in the company’s principal class of shares that are traded during that year on all other established securities markets.

The term “regularly traded” is not defined in the proposed protocol and therefore has the meaning it has under the laws of the relevant treaty country, usually the source country. In the United States, the term has the same meaning as it does under Treas. Reg. section 1.884-5(d)(4)(i)(B). Based on that provision, the Technical Explanation states that a class of shares is regularly traded if (1) trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year and (2) the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year. The Technical Explanation notes that trading on one or more recognized stock exchanges may be aggregated for purposes of meeting the “regularly traded” requirement.

The term “recognized stock exchange” means the NASDAQ System owned by the National Association of Securities Dealers, Inc.; any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; Canadian stock exchanges that are “prescribed stock exchanges” or “designated stock exchanges” under the Income Tax Act; and any other stock exchange agreed upon by the competent authorities of the treaty countries. According to the Technical Explanation, the Canadian stock exchanges that were recognized stock exchanges at the time of signing of the proposed protocol are the Montreal Stock Exchange, the Toronto Stock Exchange, and Tiers 1 and 2 of the TSX Venture Exchange.

The Technical Explanation states that the U.S. interpretation of “primarily traded” and “regularly traded” will be considered to apply under the treaty, with such modifications as circumstances require, for purposes of Canadian taxation, subject to the adoption by Canada of other definitions.

A company that does not satisfy the primarily and regularly traded test (because, for example, its shares are not publicly traded) may be entitled to treaty benefits if shares representing more than 50 percent of its aggregate voting power and value (and more than 50 percent of the voting power and value of each disproportionate class of its shares) are owned, directly or indirectly, by five or fewer companies or trusts that satisfy the primarily and regularly traded test, provided that, in the case of indirect ownership, each intermediate owner is a qualifying person. This rule allows certain subsidiaries of publicly traded companies and trusts to be eligible for all benefits under the treaty.

The 50-percent portion of this rule for subsidiaries applies only to shares that are other than debt substitute shares. The term “debt substitute shares” means shares described in paragraph (e) of the definition of “term preferred share” in the Income Tax Act, as it may be amended from time to time without changing the general principle thereof, and such other types of shares agreed upon by the competent authorities of the treaty countries.

The Technical Explanation notes that by applying the principles introduced by the proposed protocol in the context of this rule, one looks through entities in the chain of ownership that are viewed as fiscally transparent under the domestic laws of the country of residence (other than entities that are resident in the source country).

Ownership and base erosion tests

A company or trust that is a resident of one of the treaty countries is entitled to treaty benefits if it satisfies both an ownership test and a base erosion test.

An entity that is a resident of a treaty country satisfies the ownership test if on at least half the days of the taxable year shares or other beneficial interests representing 50 percent or more of the entity’s aggregate voting power and value (and 50 percent or more of any disproportionate class of its shares) are not owned, directly or indirectly, by persons other than qualifying persons. The ownership test is applied without considering debt substitute shares, which have the same meaning as described above.

The Technical Explanation states that the ownership test is intended to make clear that the test is not satisfied if, for example, a Canadian company is more than 50-percent owned by a U.S.-resident company that is, itself, wholly owned by a third-country resident. In such a case, the Canadian company does not satisfy the ownership test because more than 50 percent of its shares are owned indirectly by a person (the third-country resident) that is not a qualifying person. However, the Technical Explanation states that it is understood by the treaty countries that if at least 50 percent of a U.S. or Canadian company is owned, directly or indirectly, by a second company or trust that satisfies the publicly traded test, then no further analysis of the first company's ownership is required for purposes of determining whether the first company satisfies the ownership test.

The base erosion test is satisfied only if less than 50 percent of the person's gross income for the entity's preceding fiscal period (or, in the case of its first fiscal period, that period), as determined in that person's country of residence, is paid or accrued, directly or indirectly, in the form of payments deductible in the person's country of residence, to persons who are not qualifying persons.

The Technical Explanation notes that by applying the principles introduced by the proposed protocol in the context of this rule, one looks through entities in the chain of ownership that are viewed as fiscally transparent under the domestic laws of the country of residence (other than entities that are resident in the source country).

The Technical Explanation states that the look-through principles introduced by the proposed protocol are to be taken into account when applying the ownership and base erosion provisions. Thus, one looks through entities that are viewed as fiscally transparent under the domestic laws of the country of residence (other than entities that are resident in the source country).

Estates

The proposed protocol provides that an estate resident in the United States or Canada is entitled to all treaty benefits.

Not-for-profit organizations

A not-for-profit organization, which is an entity established in a treaty country that is generally exempt from tax in that country, is entitled to treaty benefits if more than 50 percent of the organization's beneficiaries, members, or participants are qualifying persons. Not-for-profit organizations include private foundations, charities, trade unions, trade associations, and similar organizations.

Pension or employee benefit organizations

A trust, company, organization, or other arrangement is entitled to treaty benefits if it is a resident of one of the treaty countries, is generally exempt from income taxation in its country of residence, and is established primarily to provide pension, retirement, or employee benefits to individuals resident in either the United States or Canada, or to persons who were, within the five preceding years, qualifying persons. The Technical Explanation states that a trust, company,

organization, or other arrangement is considered to be established for the purpose of providing benefits primarily to such persons if more than 50 percent of its beneficiaries, members, or participants are such persons.

Organizations that earn income for not-for-profit or pension organizations

A trust, company, organization, or other arrangement is entitled to treaty benefits if it is a resident of one of the treaty countries, is generally exempt from income taxation in its country of residence, and is established to earn income for the benefit of one or more not-for-profit organizations or pension or employee benefit organizations.

Active business test

Under the proposed protocol, a resident of one treaty country is entitled to treaty benefits with respect to an item of income derived from the other country if (1) the resident (or a person related thereto, which, according to the Technical Explanation, is determined under the principles of Code section 482 in the United States and section 251 of the Income Tax Act in Canada) is engaged in the active conduct of a trade or business in its residence country, (2) the income from the other country is derived in connection with or is incidental to the trade or business in the residence country (including any such income derived directly or indirectly by that resident person through one or more other persons who are residents of that other country), and (3) the trade or business in the residence country is substantial in relation to the activity carried on in the other country giving rise to the income in respect of which benefits under the treaty are claimed. The proposed protocol provides that the business of making or managing investments does not constitute an active trade or business unless those activities are carried on with customers in the ordinary course of business by a bank, an insurance company, a registered securities dealer, or a deposit-taking financial institution.

The term “trade or business” is not defined in the proposed protocol, and the Technical Explanation does not elaborate on its meaning.

The Technical Explanation elaborates on the requirement that an item of income from the source country be derived “in connection with” or be “incidental to” the resident’s trade or business in its residence country. The Technical Explanation provides that an item of income is derived in connection with a trade or business if, for example, the income-producing activity in the source country is upstream, downstream, or parallel to the activity conducted in the other country. Income is considered incidental to a trade or business if, for example, it arises from the short-term investment of working capital of the resident in securities issued by persons in the source country.

According to the Technical Explanation, an item of income may be considered to be earned in connection with or to be incidental to an active trade or business in one of the treaty countries even though the resident claiming the benefits derives the income directly or indirectly through one or more persons that are residents of the other treaty country. For example, a Canadian resident could claim benefits with respect to an item of income earned by a U.S. operating subsidiary, but derived by the Canadian resident through a wholly owned U.S. holding company interposed between it and the operating subsidiary. Another example is a Canadian

partnership, wholly owned in equal parts by three unrelated Canadian companies, that forms a wholly owned U.S. holding company with a U.S. operating subsidiary. In this case, the Canadian partners may claim treaty benefits with respect to income derived through the U.S. holding company, even if the partners were not considered related to the U.S. holding company under the principles of Code section 482.

The Technical Explanation explains that the substantiality requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (that is, activities that have little economic cost or effect with respect to the company business as a whole). To satisfy the substantiality requirement, therefore, it is not necessary that the trade or business in the residence country be as large as the income-producing activity in the source country. However, the trade or business in the residence country cannot, in terms of income, assets, or similar measures, represent only a very small percentage of the size of the activity in the source country.

Derivative benefits rule

The proposed protocol includes derivative benefits rules that are generally intended to allow a treaty-country company treaty benefits for dividend, interest, and royalty income if the company's owners would have been entitled to the same benefits for the income had those owners derived the income directly. Under these derivative benefits rules, a treaty country company is eligible for treaty benefits for an item of income only if the company satisfies both an ownership requirement and a base erosion requirement.

A company satisfies the ownership requirement if shares representing more than 90 percent of the company's aggregate voting power and value, and at least 50 percent of any of the company's disproportionate class of shares (in neither case including debt substitute shares), are owned, directly or indirectly, by persons who are qualifying persons or who satisfy additional requirements described below. The terms "disproportionate class of shares" and "debt substitute shares" have the same definitions as the definitions previously described.

Share ownership by persons who are not qualifying persons may count for purposes of satisfying the ownership requirement if three requirements are satisfied. First, the person must be a resident of a third country with which the treaty country that is granting benefits has a comprehensive income tax treaty (and "applicable treaty") and must be entitled to all treaty benefits provided under that treaty. Second, the person would qualify for treaty benefits with respect to the item of income for which benefits are sought as a qualifying person or under the active trade or business test of the proposed protocol if that person were a resident of the treaty country that is not providing benefits for the item of income and if the business it carries on in its country of residence were carried on in that treaty country. Third, the person would be entitled under an applicable treaty to a rate of tax on that income that is at least as low as the rate applicable under the present treaty (the "tax rate test").

A company satisfies the base erosion requirement for an item of income only if less than 50 percent of the person's gross income for the entity's preceding fiscal period (or, in the case of its first fiscal period, that period), as determined in that person's country of residence, is paid or

accrued, directly or indirectly, in the form of payments deductible in the person's country of residence, to persons who are not qualifying persons. The Technical Explanation notes that the base erosion requirement under the derivative benefits rule is qualitatively the same as the base erosion test described previously.

Grant of treaty benefits by the competent authority

Under the proposed protocol, a resident of a treaty country that is not otherwise entitled to treaty benefits under this article may nonetheless be granted treaty benefits if the competent authority of the other treaty country determines (1) that the creation and existence of the resident did not have as one of its principal purposes the obtaining of benefits under the treaty that would not otherwise be available or (2) that it would not be appropriate, having regard to the purpose of this article, to deny benefits of the treaty to the resident. In making these determinations, the competent authority will consider all factors, including the history, structure, ownership, and operations of the resident for whom benefits are sought. The Technical Explanation notes that if the competent authority decides to grant benefits, it may grant all treaty benefits or may grant benefits on an item-by-item basis.

According to the Technical Explanation, for purposes of implementing this provision, a taxpayer is permitted to present his or her case to the competent authority for an advance determination based on a full disclosure of all pertinent information. The taxpayer is not required to wait until it has been determined that benefits are denied under one of the other provisions of this article. It is also expected that, if and when the competent authority determines that benefits are to be allowed, they will be allowed retroactively to the time of entry into force of the relevant provision of the treaty or the establishment of the structure in question, whichever is later (assuming that the taxpayer also qualifies under the relevant facts for the earlier period).

Interaction with general anti-abuse provisions

The proposed protocol includes a rule substantively similar to a rule in the present treaty addressing the interaction of the article with general anti-abuse provisions. Specifically, the proposed protocol provides that Article XXIX A will not be construed as restricting in any manner the right of a treaty country to deny benefits under the treaty in any case in which it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the treaty. The Technical Explanation states that this provision permits a treaty country to rely on general anti-abuse rules to counter arrangements involving treaty shopping through the other treaty country.

Thus, according to the Technical Explanation, Canada may apply its domestic law rules to counter abusive arrangements involving treaty shopping through the United States, and the United States may apply its substance-over-form and anti-conduit rules, for example, in relation to Canadian residents. The Technical Explanation states that this principle is recognized by the Commentaries to the OECD Model treaty, and that the United States and Canada agree that it is inherent in the treaty; the statement of this principle explicitly in the proposed protocol is not intended to suggest that the principle is not also inherent in other treaties concluded by the United States or Canada.

Article 26. Taxes Imposed by Reason of Death

Article XXIX B of the existing treaty provides rules coordinating the treaty countries' imposition of taxes (for example, the U.S. estate tax and the Canadian capital gains tax) when a resident of one of the treaty countries dies. The proposed protocol's changes to these rules generally are intended to address certain concerns regarding the application of Canadian tax rules and regarding the availability of tax credits or deductions when the United States and Canada impose tax on the same items of income or property.

The existing treaty includes a rule addressing the imposition of tax when an individual resident of a treaty country dies and passes property to a tax-exempt organization described in paragraph 1 of Article XXI. The rule provides that the tax consequences in the individual's country of residence are determined by treating the organization receiving the property as if it were a resident of that country. The proposed protocol replaces this rule with two rules, one that applies when property of an individual U.S. resident passes at that individual's death to a Canadian exempt organization and the other that applies when property of an individual Canadian resident passes at that individual's death to a U.S. exempt organization. Under the former rule, as in the existing treaty, the tax consequences in the United States are determined by treating the Canadian organization as if it were a resident of the United States. Under the latter rule, the tax consequences in Canada are determined by assuming the individual had disposed of the property for proceeds equal to an amount elected on behalf of the individual for this purpose (in a manner specified by the Canadian competent authority), with the amount being no less than the individual's cost of the property determined for Canadian tax purposes and no more than the property's fair market value.

Under the rule for property passing from a U.S. individual resident to a Canadian exempt organization, the U.S. individual's estate generally will be entitled to a charitable deduction for U.S. Federal estate tax purposes in an amount equal to the value of the property transferred.

According to the Technical Explanation, the rule for property passing from a Canadian individual resident to a U.S. exempt organization is intended to address questions that have arisen about the application of the existing treaty rule when a Canadian resident dies and passes property to a U.S. charitable organization that is not a "registered charity" under Canadian law. As a result of the rule, if an election is made to treat the Canadian individual as having disposed of the property for an amount of proceeds that results in no capital gain, no capital gains tax in Canada will be imposed. The rule does not, however, change the separate limitation (in paragraph six of Article XXI of the existing treaty) on the amount of the charitable deduction allowed under the separate Canadian income tax.

The Technical Explanation notes that the proposed protocol's rules for cross-border transfers at death to charitable organizations do not address the situation in which a resident of one treaty country bequeaths property situated in the other treaty country to an exempt organization in the decedent's country of residence. If, for example, the property in question is real property situated in the other treaty country, then, according to the Technical Explanation, that country may impose tax by reason of the decedent's death.

The existing treaty includes rules addressing whether a deferral of tax (a “rollover”) is available under Canadian law when property is transferred to a surviving spouse or a trust. Normally under Canadian law, a taxpayer is deemed to realize accrued gains in property when the taxpayer dies, and the deemed realization is subject to tax. Certain transfers to surviving spouses and trusts, however, are eligible for a rollover of gains. A rollover is available only if both spouses were Canadian residents. The changes that the proposed protocol makes to the existing rules are technical in nature and are, according to the Technical Explanation, intended to ensure that rollover of the Canadian tax at death is available for transfers to a surviving spouse or to a trust in certain circumstances. The Technical Explanation describes one such circumstance: A U.S. decedent with a Canadian spouse sets up a qualified domestic trust holding U.S. and Canadian real property, and the decedent’s executor elects to treat the entire trust as qualifying for the U.S. Federal estate tax marital deduction. A rollover under Canadian law would not be available because the decedent is not a Canadian resident; Canada therefore would impose capital gains tax on the deemed disposition of the Canadian property immediately before death. The rule in the proposed protocol, however, has the result of permitting a rollover. The Technical Explanation states that the changes in the proposed protocol do not affect U.S. internal law concerning qualified domestic trusts and do not affect the status of U.S. resident individuals for any other purpose.

The notes include three clarifications of rules in the existing treaty. These clarifications, according to the Technical Explanation, are intended to ensure that in certain targeted circumstances, tax credits or deductions in one treaty country are available against tax imposed in the other treaty country by reason of the death of a treaty country resident.

One clarification applies when, according to the Technical Explanation, an individual who immediately before death was a resident of Canada held at the time of death stock or a stock option that is considered U.S.-situated property under this article and that Canada treats as giving rise to employment income. In this situation, the transfer of the stock or option at death may be subject to U.S. estate tax, and the employment income may be subject to Canadian income tax. Under the clarification, employment income in respect of the stock or option is treated as income from property situated in the United States. Accordingly, U.S. estate tax is allowable as a deduction from Canadian income tax.

A second clarification applies when an individual who immediately before death was a Canadian resident held a Canadian-resident registered retirement savings plan (“RRSP”) or other entity operated exclusively to provide retirement or similar benefits, and the RRSP or other entity held property situated in the United States. In this circumstance, the United States would impose estate tax, to the extent permitted by U.S. law, on the transfer of the U.S. property held in the RRSP or similar entity, and Canada would impose income tax on the deemed distribution of the property. The clarification provides that, for purposes of determining the amount of Canadian tax that is payable, any income out of or under the entity in respect of the property is treated as income from property situated in the United States. This rule ensures, according to the Technical Explanation, that U.S. estate tax paid on the U.S. property is allowable as a deduction against Canadian income tax.

A third clarification applies when an individual who was a U.S. resident immediately before death held at the time of death a Canadian-resident RRSP or other similar entity. In this

circumstance, the United States would impose estate tax on the value of the property in the RRSP or other entity, and Canada would impose income tax on a deemed distribution of the property. The clarification provides that, for purposes of determining the amount of U.S. tax that is payable, the Canadian tax is imposed in respect of property situated in Canada, thereby ensuring that Canadian income tax will be allowable as a credit against the U.S. estate tax.

Article 27. Entry into Force

The proposed protocol provides that it is subject to ratification in accordance with the applicable procedures of each country. The United States and Canada are each to notify the other in writing, through diplomatic channels, when it has completed the required procedures. Generally, the proposed protocol will enter into force on the date of the latter notification.⁸⁸ The Technical Explanation clarifies the rule, stating the relevant date is the date of the latter notice, and not the date on which the notice is received by the other treaty country.

Once the proposed protocol enters into force, paragraph 2 of Article 27 (Entry into Force) describes when specific tax provisions take effect. First, subparagraph 2(b) implements the effective date with respect to taxes withheld at the source on the first day of the second month that begins after the date on which the proposed protocol enters into force. For example, if the proposed protocol enters into force on September 15, 2008, then October is the first month that begins following that date, and November is the second month that begins following that date. Accordingly, the new withholding tax provisions will apply with respect to amounts paid or credited on or after November 1, 2008.

Second, with respect to other taxes, subparagraph 2(b) implements the provisions of the proposed protocol for taxes chargeable to tax years that begin after the calendar year in the proposed protocol enters into force.⁸⁹ For example, if the proposed protocol enters into force on September 15, 2008, then, with respect to a calendar year taxpayer, January 1, 2009 is the first tax year that begins following the calendar year in which the proposed protocol enters in force. With respect to a fiscal year taxpayer whose tax year commences on December 1, the terms of the proposed protocol do not apply with respect to other taxes until December 1, 2009.

In addition, subparagraphs 3(a) through (g) provide distinct effective dates for specific items in the proposed protocol. First, under subparagraph 3(a), paragraph 1 of Article 2 (Residence) of the proposed protocol is retroactively effective with respect to corporate

⁸⁸ Had the required notifications taken place before the end of 2007, the proposed protocol would have entered into force on January 1, 2008.

⁸⁹ Had the required notifications taken place before the end of 2007, subparagraph 2(b) provided that, with respect to other taxes, the provisions would have effect for taxes chargeable to tax years beginning in and after the calendar year in which the proposed protocol entered into force. Thus, had the required notifications taken place before the end of 2007, the proposed protocol would have entered into force on January 1, 2008. With respect to taxes other than withholding at the source, these provisions would have taken effect simultaneously on January 1, 2008.

continuations⁹⁰ effected after September 17, 2000. This modification affects the rules of paragraph 3 of Article IV (Residence), which provide a tie breaker when there is dual residency. As noted in the Technical Explanation, the United States and Canada issued a joint press release on September 17, 2000, which (1) identified certain dual residency issues, (2) expressed the intention of the countries to negotiate a protocol to the present treaty addressing these issues, and (3) stated that the relevant terms of such protocol would be retroactive to the press release date if such protocol were ever approved. The dual residency issue that had been raised at that time with respect to corporate continuances involved inconsistent positions that were being asserted by some taxpayers. At issue were U.S. corporations that had continued into Canada while retaining their status as U.S. corporations under internal U.S. law. The argument made by some was that the corporation would, by virtue of the present treaty, be a resident only of Canada but that it would also, for certain other U.S. tax purposes, retain its status as a U.S. corporation under internal U.S. law.

In addition, the effective date of new paragraph 7, which is added to Article IV (Residence) of the present treaty by Article 2 (Residence) of the proposed protocol, is directed by subparagraph 3(b) of Article 27 (Entry in Force). This new paragraph 7 describes the treatment of certain payments through fiscally transparent entities. Subparagraph 3(b) states that this provision is effective as of the first day of the third calendar year that ends after the proposed protocol enters into force. This provision is applied on a calendar year basis. For example, if the proposed protocol comes into force during 2008, then 2008 is the first calendar year that ends after the proposed protocol enters into force, and 2010 would be the third calendar year that ends after the proposed protocol enters into force. Accordingly, the earliest that new paragraph 7 of Article IV (Residence) of the present treaty could enter into force is the first day of calendar 2010, which is January 1, 2010.

Subparagraph 3(c) provides the effective dates for Article 3 (Permanent Establishment) of the proposed protocol, which modifies Article V (Permanent Establishment) of the present treaty. As with subparagraph 3(b), the modifications to Article 3 (Permanent Establishment) are effective as of the third year that ends after the year in which the proposed protocol enters into force. However, unlike subparagraph 3(b), this provision is applied on a fiscal-year basis. The reason for this distinction is to ensure that no taxpayer is considered to have a permanent establishment by reason of subparagraph 3(c) for a partial tax year. Thus, if the proposed protocol enters into force on September 15, 2008, then for a calendar year taxpayer, the first tax year that ends after proposed protocol enters into force is December 31, 2008, and December 31, 2010 is the third such year. Accordingly, subparagraph 3(c) is effective on January 1, 2010 for a calendar year taxpayer. In counting the relevant (1) number of days present, (2) services rendered, or (3) gross active business revenues for purposes of establishing whether there is a permanent establishment for the fiscal year beginning January 1, 2010, only those (1) days

⁹⁰ Under the laws of both the United States and Canada, a company incorporated in one jurisdiction is allowed to subject itself to the corporate laws of another jurisdiction. When this happens, a company originally formed in one jurisdiction is said to have “continued” into the other jurisdiction. Once continued into the other jurisdiction, that company is treated for company law purposes as though it had been incorporated there.

present, (2) services rendered, and (3) gross active business revenues which occur or arise on or after January 1, 2010, will be taken into account. Alternatively, if the proposed protocol enters into force on September 15, 2008, then for a taxpayer with a May 31 fiscal year end, the first tax year that ends after proposed protocol enters into force is May 31, 2009, and May 31, 2011, is the third such year. Accordingly, subparagraph 3(c) is effective on June 1, 2010 for this fiscal year taxpayer. In counting the relevant (1) number of days present, (2) services rendered, or (3) gross active business revenues for purposes of establishing whether there is a permanent establishment for the fiscal year beginning June 1, 2010, only those (1) days present, (2) services rendered, and (3) gross active business revenues which occur or arise on or after January 1, 2010, will be taken into account.

If the proposed protocol enters into force before the end of 2008, application of the rule will have a distinctive result for any taxpayer with a fiscal year end that falls between the date on which the proposed protocol enters into force and December 31, 2008. For example, if the proposed protocol enters into force on September 15, 2008, then for a taxpayer with a November 30 fiscal year end, the first tax year that ends after proposed protocol enters into force is November 30, 2008 and November 30, 2010 is the third such year. Accordingly, subparagraph 3(c) is effective on December 1, 2009 for this fiscal year taxpayer. However, in counting the relevant (1) number of days present, (2) services rendered, or (3) gross active business revenues for purposes of establishing whether there is a permanent establishment for the fiscal year beginning December 1, 2009, only those (1) days present, (2) services rendered, and (3) gross active business revenues which occur or arise on or after January 1, 2010 will be taken into account.

Subparagraph 3(d) describes phased-in effective dates for the withholding tax rates on cross-border interest payments as provide by Article 6 (Interest) of the proposed protocol. Under the new terms provided by this article, the country of the recipient's residence will have the exclusive right to tax interest that arises in the other treaty country. Accordingly, the withholding tax rate on interest will be zero. This zero-rate withholding will be phased in over two years with respect to (1) interest paid between related persons, or persons who are deemed to be related under paragraph 2 of Article IX (Related Persons)⁹¹ of the present treaty, where (2) the interest would not be exempt from withholding taxes under paragraph 3 of Article XI (Interest) of the present treaty (i.e., under the terms of the present treaty prior to the effective date of the proposed protocol). Under the special phase-in rules, the treaty country from which such interest is paid may impose a withholding tax of up to seven percent during the first calendar year that ends following the date on which the proposed protocol enters into force, and may impose a withholding tax of up to four percent during the second calendar year that ends following the date on which the proposed protocol enters into force. Thus, if the proposed protocol enters into force during 2008, then the treaty country from which such interest is paid may impose a withholding tax of up to seven percent with respect to interest that is paid or credited during 2008, and may impose a withholding tax of up to four percent with respect to interest that is paid

⁹¹ Under paragraph 2 of Article IX (Related Persons) of the present treaty, the parties would be deemed to be related if one party participates directly or indirectly in the management or control of the other, or, if a third person participates directly or indirectly in the management or control of both.

or credited during 2009. As noted by the Technical Explanation, the effect of these provisions is to apply the terms of Article 6 (Interest) retroactively.

Paragraphs 2 and 3 of Article 8 (Gains) of the proposed protocol describe the treatment of alienations, and deemed alienations, of property. Under subparagraph 3(e), these paragraphs apply retroactively to September 17, 2000. As noted above, this is the date on which the United States and Canada issued a joint press release, announcing the intention of the countries to negotiate a protocol to the present treaty. In this press release, the United States and Canada announced that the new protocol would coordinate the tax treatment of an emigrant's gains. The press release also announced that the relevant terms of such protocol would be retroactive to the press release date if such protocol were ever approved.

Subparagraph 3(f) provides the implementation rules for the new arbitration provisions of the proposed protocol, which are contained in Article 21 (Mutual Agreement Procedure). In general, this article provides that arbitration begins two years from the date on which a competent authority proceeding commenced if the competent authorities are not able to reach resolution during that two-year period. Subparagraph 3(f) makes it clear that cases currently with competent authority are subject to the arbitration provision. However, this provision states that the date on which the proposed protocol enters into force is the date on which an existing competent authority proceeding will be deemed to have commenced. Subparagraph 3(f) also clarifies that the arbitration provisions are effective with respect to competent authority proceedings that commence after the date on which the proposed protocol enters into force. This latter provision is intended to clarify that the effective dates described in paragraph 2 of Article 27 (Entry into Force) of the proposed protocol do not impact the effective date of the arbitration provisions.

Despite these express provisions, the Technical Explanation acknowledges that there could be a large number of cases that could go to arbitration simultaneously if there were strict adherence to the two year period rule. Therefore, the Technical Explanation calls for the competent authorities to establish and implement arbitration procedures by January 1, 2009, and to begin scheduling arbitration proceedings—presumably for the older matters that are already with competent authority at the time the proposed protocol enters into force—before the end of the two year period.

Finally, Subparagraph 3(g) describes the effective dates with respect to Article 22 (Assistance in Collection) of the proposed protocol. This article contains the provisions applicable to those situations in which the United States and Canada have agreed to assist each other in the collection of taxes. As described in subparagraph 3(g), this article is effective for revenue claims that have been definitively determined by either the United States or Canada after November 9, 1985. The Technical Explanation notes that this effective date is consistent with a previous protocol, which entered into force on November 9, 1995.

VI. ISSUES

A. Permanent Establishment by Virtue of Services

In general

The proposed protocol adds a special rule for services in paragraph 9 of Article V (Permanent Establishment) of the treaty, under which services performed by an enterprise of a treaty country in the other treaty country (the “services country”) may give rise to a permanent establishment there, even in the absence of a permanent establishment under another paragraph of Article V. If paragraph 9 applies, the services are taxed on a net basis under Article VII (Business Profits) of the treaty as modified by the proposed protocol, and, therefore, such taxation is limited to the profits attributable to the activities carried on in performing those services. The effect of this provision is that the services country is more likely to be able to impose its tax on profits of business enterprises that are resident in the other treaty country, even though this tax is limited to profits from the permanent establishment.

The provision is intended to reverse the result of the Canadian Federal Court of Appeal decision in *The Queen v. Dudney*,⁹² in which a U.S. independent contractor was held not to have a Canadian “fixed base” (which the court recognized to have substantially the same meaning as “permanent establishment”), even though the contractor spent substantial time at his customer’s premises during the course of two consecutive calendar years.

Developing country treaty provision

The United States has negotiated several tax treaties that contain a similar rule providing that cross-border services may give rise to a permanent establishment under certain circumstances. The circumstances that may give rise to a permanent establishment under those treaties, as well as the relevant time periods that will trigger the provision, generally vary by treaty. These treaties include the U.S.-India treaty (1989), the U.S.-Philippines treaty (1976), the U.S.-Slovak Republic treaty (1993), the U.S.-Venezuela tax treaty (1999), and the U.S.-Thailand treaty (1996). The proposed U.S.-Bulgaria treaty also contains a provision very similar to the provision in the proposed protocol.

All of these treaties are with developing countries.⁹³ The U.S.-Canada treaty would be the first U.S. tax treaty with a developed country containing such a provision. A developing country may request such a provision because there may be a significant imbalance in the amount of cross-border services provided to persons in the developing country, as compared with the amount of cross-border services provided by persons resident there. Further, a developing country may be concerned that foreign enterprises may be able to carry on a substantial level of business activities therein without the need for a fixed place of business within its territory. The

⁹² 99 DTC 147 (T.C.C.), *aff’d*, 2000 DTC 6169 (F.C.A.).

⁹³ The United Nations Model Taxation Convention between Developed and Developing Countries (January 11, 2001) also contains such a provision.

developing country may believe that it should be able to impose its tax on profits from services performed within its territory even if such services do not involve a fixed place of business.

Because the threshold for the volume of services in the proposed protocol is significantly lower than under the U.S. Model treaty and U.S. treaties with other developed countries, the Committee may wish to inquire whether dilution of the permanent establishment standard is appropriate in the case of a treaty relationship with a developed country, particularly in the case of a country with which the United States has a very large amount of cross-border services, such as Canada.

Administrative and compliance issues

The rules of paragraph 9 may give rise to administrative and compliance issues, including the potential for excess withholding or estimated tax payments with respect to employee wages that may result from the application of paragraph 9 and its interaction with Article XV (Income from Employment), as modified by the proposed protocol. Although the Technical Explanation states that the “competent authorities are encouraged to consider adopting rules to reduce the potential for excess withholding or estimated tax payments with respect to employee wages that may result from the application of this paragraph,” it is not clear that, or how, these potential issues will be resolved. In any event, taxpayers will be required to establish systems and processes to address these matters, some of which affect the enterprise and some of which affect its employees.

Enterprise issues

Some of the issues that may arise under paragraph 9 result from the fact that an enterprise with a deemed permanent establishment in another country that is not an actual fixed base is unlikely to have the requisite infrastructure in that other country to comply with the rules of paragraph 9. For example, such an enterprise is unlikely to keep in the services country a full set of enterprise financial records or records tracking its employees’ activities there. Such records will likely have to be established and maintained in the enterprise’s home country. In addition, there will probably be no permanent employees in the services country to implement the enterprise’s tax compliance efforts, including the payment or deposit of any required estimated taxes, and the filing of tax returns with the various levels of government. It may be necessary for the enterprise to anticipate that it might later be deemed to have a permanent establishment under this provision. Depending on the situation, that may be difficult or impossible to foresee (for example, if planned project deadlines are not met due to unanticipated circumstances, or services are unexpectedly required to be performed for more than 183 days in order to finish the work).

Employee-employer issues

The potential triggering of a permanent establishment raises several issues for the employees involved as well as for the enterprise in its capacity as employer.

Under Article XV of the treaty, as modified by the proposed protocol, remuneration of an employee who is a resident of a treaty country is generally taxable only in that treaty country unless the employment is exercised in the other treaty country (i.e., the services country). In the case of such cross-border employment, the proposed protocol provides that the remuneration

derived by the employee from the exercise of employment in the other treaty country may be taxed by the services country if both of the following conditions are met: (1) such remuneration exceeds \$10,000 in a calendar year; and (2) the recipient is present in the services country for a period or periods equal to or exceeding in the aggregate 183 days in any 12-month period commencing or ending in the fiscal year concerned, the remuneration is paid by (or on behalf of) a person who is a resident of the services country, or the remuneration is borne by a permanent establishment in the services country.⁹⁴

Thus, an employee earning \$10,001 in a calendar year through a permanent establishment arising under new paragraph 9 of Article V of the treaty would be subject, under Article XV of the treaty, to income taxation by the services country on the remuneration from such exercise of employment. This may give rise to several tax-related obligations on the part of the employee and the employer, including the registration and the obtaining of tax identification numbers, withholding and deposit of income taxes and other taxes with respect to both the employer and the employee (covering the period beginning on the first day such services were performed by such employee during the year), and in the case of an enterprise that is a partnership, the filing of income tax returns on behalf of the partners. The Committee may wish to inquire whether and how the administrative and compliance issues described above have been (or will be) addressed by the treaty partners.

The draft OECD Model treaty commentary

On April 21, 2008, the OECD issued a draft update to its Model treaty.⁹⁵ The OECD update includes amendments to the commentary that generally address the tax treaty treatment of services. The draft commentary also includes an example of an alternative services permanent establishment provision that, according to the commentary, treaty countries “are free to agree bilaterally to include . . . in their tax treaties.”⁹⁶

Although the alternative OECD language is generally similar to that of the proposed protocol, there are some notable differences. Most significantly, the alternative OECD language clarifies when services performed by an individual on behalf of one enterprise may be considered as performed by another enterprise through that individual. Under the alternative OECD provision, such attribution may occur only if the other enterprise supervises, directs, or controls the manner in which the services are performed by the individual. The proposed protocol and the Technical Explanation are silent on this point, leaving open the question whether, and if so,

⁹⁴ For this purpose, a permanent establishment bears the remuneration if the remuneration is allowable as a deduction in computing the taxable income of the permanent establishment.

⁹⁵ *Draft Contents of the 2008 Update to the Model Tax Convention*, OECD Centre for Tax Policy and Administration (April 21, 2008). The OECD reportedly announced it will soon release the final version of the update, which the OECD is expected to formally approve on July 17, 2008. Thus, it is possible that the final version differs from the publicly-released draft update described herein. See *OECD Updates Model Tax Convention*, 2008 Worldwide Tax Daily 127-1 (July 1, 2008).

⁹⁶ *Annex I to the Draft Contents of the 2008 Update to the Model Tax Convention*, par. 42.23, OECD Centre for Tax Policy and Administration (April 21, 2008).

under what circumstances, the use of a subcontractor might give rise to a permanent establishment of a general contractor under paragraph 9.

There are two other significant differences between paragraph 9 and the alternative OECD provision. First, unlike new paragraph 9(b) of Article V of the treaty, corresponding subparagraph (b) of the alternative OECD provision is clear on its face that the individuals must be physically present in the services country. In this regard, however, the Technical Explanation clarifies that physical presence is required under the proposed protocol. Second, under the proposed protocol, in order for projects to be considered to be connected, they must constitute a coherent whole, both commercially and geographically. Geographic coherence is not required under the alternative OECD provision.

The Committee may wish to inquire regarding the circumstances, if any, which might give rise to a permanent establishment for a general contractor that hires a local or other subcontractor but does not send any of its own employees to perform services in the services country.

B. Payments Derived Through or Made by Fiscally Transparent Entities

In general

Article 2, paragraph 2 of the proposed protocol adds paragraphs 6 and 7 to Article IV (Residence) of the present treaty. These new paragraphs provide specific rules for the treatment of amounts of income, profit, or gain derived through or paid by fiscally transparent entities. Paragraph 6 sets forth the “positive” rule of derived income that an amount of income, profit, or gain is considered to be derived by a resident of a treaty country if (1) that person is considered under the tax law of that country to have derived the amount through an entity, other than an entity that is a resident of the other treaty country, and (2) by reason of that entity being treated as fiscally transparent under the laws of the first treaty country, the treatment of the amount under the tax law of the country of residence is the same as its treatment would be if that amount had been derived directly by that person.

The rule of paragraph 6 is similar in scope and effect to the rule of Article 1, paragraph 6 of the U.S. Model treaty, which provides “[a]n item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.” The Technical Explanation to the U.S. Model treaty states that the two goals of that provision are (1) to eliminate technical problems that would have prevented investors using such entities from claiming treaty benefits, and (2) to prevent the use of such entities to claim treaty benefits where the investors are not subject to tax on the income in their state of residence. The rule of paragraph 6 is consistent with the first goal stated above.

Similarly, the “negative” rule of paragraph 7(a) is consistent with the second goal stated above. Under subparagraph 7(a), an amount of income, profit, or gain is considered not to be paid to or derived by a person who is a resident of a treaty country if (1) that person is considered under the taxation law of the other treaty country as deriving the amount through an entity that is not a resident of the first treaty country, but (2) by reason of the entity being treated as not fiscally transparent under the laws of that treaty country, the treatment of the amount under the taxation law of that country is not the same as its treatment would be if that amount had been derived directly by the person. As more fully discussed in Section V of this document, the rule of subparagraph 7(a) mutually addresses the same factual circumstances addressed solely from the U.S. point of view by section 894(c)(1).

The rule of subparagraph 7(b), however, is new to U.S. policy and is not reflected in the U.S. Model treaty. Subparagraph 7(b) addresses whether the recipient of a payment that is made by a fiscally transparent entity to its owner is entitled to treaty benefits with respect to that payment. It provides that an amount of income, profit, or gain is not considered to be paid to or derived by a person who is a resident of a treaty country if (1) the person is considered under the tax law of the other treaty country to have received the amount from an entity resident in the other treaty country, but (2) by reason of the entity being treated as fiscally transparent under the laws of the first treaty country, the treatment of the amount received by that person under the tax law of that country is not the same as its treatment would be if the entity were treated as not fiscally transparent under the laws of that country.

Issues arising under subparagraph 7(b)

Potential overbreadth

The rules of subparagraph 7(b) are aimed largely at curtailing the use of certain legal entity structures that include hybrid fiscally transparent entities, which, when combined with the selective use of debt and equity, may facilitate the allowance of either (1) duplicated interest deductions in the United States and Canada, or (2) a single, internally generated interest deduction in one country without offsetting interest income in the other country. Such legal entity structures may be quite complex, and may involve so-called “tower financing” structures used by some Canadian companies to finance their U.S. operations⁹⁷ or legal entity structures used by some U.S. companies to finance their Canadian operations.

An example of perhaps the simplest such structure is one in which a U.S. corporation is the sole owner of a Canadian unlimited liability company (“ULC”) that is treated for Canadian tax purposes as a taxable entity in Canada (and therefore a resident of Canada) but is disregarded as an entity separate from its owner for U.S. tax purposes. A loan from the U.S. parent corporation to the ULC, and the corresponding interest payment from the ULC to its parent, would be treated as nonexistent events for U.S. tax purposes. Thus, the ULC would be entitled to a deduction for interest expense for Canadian tax purposes with no offsetting income inclusion in the United States or Canada.⁹⁸ Under present law, the U.S. parent corporation is arguably entitled to Canadian treaty benefits for the interest payment. Under subparagraph 7(b), it is clear that these treaty benefits would not be allowed.

As a general matter, it is a legitimate objective for Canada and the United States, separately or jointly, to attack these or other types of structures that give rise to double deductions (or to single deductions with no income offsets). Commentators have noted, however, that many U.S. companies utilize Canadian ULCs to structure their Canadian investments and businesses, without engaging in such potentially abusive transactions, for a variety of legitimate reasons. Legitimate reasons that a U.S. company may utilize a Canadian ULC for its operations in Canada include: to operate in branch form for U.S. tax purposes; to better manage Canadian foreign taxes for U.S. tax purposes; to increase its Canadian tax basis in Canadian assets acquired through a purchase of the stock of a Canadian company; and for other

⁹⁷ See, e.g., J. Michael Cornett, *Fifth Protocol: Proposed Amendments to United States - Canada Income Tax Treaty*, 2008 *The Tax Executive* 29; Nathan Boidman, Peter Glicklich, Michael Kandev & Abraham Leitner, *How the New Canada-U.S. Treaty Protocol Affects Business Enterprises*, 36 *Tax Management International Journal* 651 (2007); Matthew Peters & Joanna Barsky, *Canada-U.S. Tax Treaty Protocol: Where Have All the Hybrids Gone?*, 2007 *Tax Notes Today* 233-36 (Dec. 4, 2007); see also Patrick Marley & Martha McDonald, *Canada’s New Anti-Double-Dip Initiative*, 37 *Tax Management International Journal* 95 (2008); *Canada’s New Government Improves Tax Fairness With Anti-Tax-Haven Initiative*, Canada Department of Finance, Notice 2007-041 (May 14, 2007), at <http://www.fin.gc.ca/news07/07-075e.html>.

⁹⁸ In connection with such a structure, it may be possible to shift the interest deduction to other Canadian resident companies by the use of additional structures (which may include other hybrid entities).

reasons not connected with financing.⁹⁹ Such commentators would assert that many U.S.-based and Canadian-based businesses have structured their cross-border arrangements for these reasons, and, moreover, that the underlying income of both (1) Canadian ULCs directly owned by U.S. companies, and (2) U.S. corporations treated as fiscally transparent for Canadian purposes is subject to tax both by the United States and Canada.

Neither the proposed protocol nor the Technical Explanation, however, attempts to classify the use of hybrids as acceptable or unacceptable depending upon the factual circumstances. Subparagraph 7(b) also applies with respect to both nondeductible dividend payments and, at least in the case of disregarded entities (as discussed below), deductible dividend payments. As a result of the inclusion of subparagraph 7(b) in the proposed protocol, many taxpayers that have not organized their U.S.-Canada cross-border structures to obtain double deductions will have to restructure their legal entities in order to avoid double taxation.¹⁰⁰ The Committee may wish to inquire whether a rule might have been negotiated in lieu of subparagraph 7(b) that would have more narrowly targeted abusive cross-border structures while at the same time causing less disturbance to nonabusive structures.

Relationship with section 894 regulations

Some commentators believe that in the case of a Canadian investing in the United States through a domestic reverse hybrid entity, the rules of subparagraph 7(b) appear to provide a result that is both contradictory to, and harsher than, Treas. Reg. section 1.894-1(d)(2)(ii)(A). Treas. Reg. section 1.894-1(d)(2)(ii)(A) states the general rule that an item of income paid by a domestic reverse hybrid entity to a fiscally nontransparent interest holder in that entity is considered to be derived by the interest holder.¹⁰¹ A domestic reverse hybrid entity is defined as

⁹⁹ See Letter from New York State Bar Association to U.S. Department of the Treasury and Internal Revenue Service (January 29, 2008), available at http://www.nysba.org/AM/Template.cfm?Section=Tax_Section_Reports_2008&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=13327.

¹⁰⁰ The proposed protocol allows time for such restructuring. Under Article 27, paragraph 3(b) of the proposed protocol, new paragraph 7 of Article IV of the treaty is effective as of the first day of the third calendar year that ends after the proposed protocol enters into force. For example, if the proposed protocol comes into force before December, 31, 2008, paragraph 7 will be effective on January 1, 2010.

¹⁰¹ The regulations state an exception to that general rule in the situation in which a domestic entity makes a payment to a related domestic reverse hybrid entity that (1) is treated as a dividend under either U.S. law or the law of the jurisdiction of a related foreign interest holder in the domestic reverse hybrid entity, and (2) under the laws of the jurisdiction the related foreign interest holder is treated as deriving its proportionate share of the payment. If the domestic reverse hybrid entity makes a payment that is deductible for U.S. tax purposes to the related foreign interest holder, or to a person whose income may offset the income of the related foreign interest holder, and such payment would be eligible for a reduction in withholding under a U.S. tax treaty, such payment is recharacterized as a dividend to the extent of the amount of the dividend described above received by the domestic reverse hybrid entity, for purposes of the Code and any applicable income tax treaty. Treas. Reg. sec. 1.894-1(d)(2)(ii)(B). However, in many, if not most, circumstances, this exception will not apply.

a domestic (U.S.) entity that is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of the interest holder's jurisdiction with respect to an item of income received by the domestic entity.¹⁰² Such commentators question, therefore, whether subparagraph 7(b) is contrary to paragraph 1 of Article XXIX of the treaty, which provides that the provisions of the treaty shall not restrict in any manner any exclusion, exemption, deduction, credit or other allowances now or hereafter accorded by the laws of a treaty country in the determination of the tax imposed by that country. The Technical Explanation to the 1980 U.S.-Canada treaty, in which this provision appears, states in part that, "if a deduction would be allowed for an item in computing the taxable income of a Canadian resident under the Code, such deduction is available to such person in computing taxable income under the Convention. . . . In no event are the rules of the Convention to increase overall U.S. tax liability from what liability would be if there were no convention."

The Technical Explanation to the proposed protocol appears to address this concern. It states (with reference to payments under new paragraphs 6 and 7 of Article IV of the treaty) that "[a]dditionally, for purposes of application of the Convention by the United States, the treatment of such payments under Code section 894(c) and the regulations thereunder would not be relevant." In this regard, the same regulations state that the rules of the regulation described above apply in respect of all U.S. income tax treaties

unless otherwise explicitly agreed upon in the text of an income tax treaty. . . .
[T]he competent authorities may agree on a mutual basis to depart from the rules contained in this paragraph (d) in appropriate circumstances. However, a reduced rate under a tax treaty for an item of U.S. source income paid will not be available irrespective of the provisions in this paragraph (d) to the extent that the applicable treaty jurisdiction would not grant a reduced rate under the tax treaty to a U.S. resident in similar circumstances. . . .¹⁰³

Thus, Treas. Reg. section 1.894-1(d)(2)(ii)(A) appears to be generally consistent with those matters explicitly agreed upon in subparagraph 7(b) because the regulation, by its terms, is subordinate to a contrary treaty rule. Therefore, the rule of paragraph 1 of Article XXIX appears not to apply to that extent. As discussed below, however, there remains some uncertainty regarding deductible payments made by a domestic reverse hybrid partnership entity to one of its Canadian owners.

The Committee may wish to inquire regarding the relationship between the regulations discussed above and subparagraph 7(b).

Because subparagraph 7(b) applies to deny treaty benefits to both deductible and nondeductible payments (and the U.S. domestic withholding rate is 30 percent regardless of deductibility), subparagraph 7(b) is consistent with the exception.

¹⁰² Treas. Reg. sec. 1.894-1(d)(2)(i).

¹⁰³ Treas. Reg. sec. 1.894-1(d)(4).

Application of subparagraph 7(b) to deductible payments by partnerships

Disregarded entities

The Technical Explanation provides several examples of the application of subparagraph 7(b) to certain legal entity structures. One example involves a U.S. company that is the sole owner of a Canadian company that is a resident of Canada under Canadian tax law, but which for U.S. tax purposes is disregarded as an entity separate from its owner. The example provides that subparagraph 7(b) applies to dividend, interest, or royalty payments made by the Canadian company to its U.S. owner. A similar example is provided of a Canadian-resident company, CanCo, which is the sole owner of an entity that is considered to be a corporation resident in the United States for U.S. tax purposes, but which is considered to be a U.S. branch of CanCo for Canadian tax law purposes. Again, the example provides that subparagraph 7(b) applies to dividend, interest, or royalty payments made by the U.S. entity to its owner.

Partnerships

In an example relating to partnerships, CanCo is a Canadian entity that is a corporate resident of Canada under Canadian tax law, but which is a partnership for U.S. tax purposes. A U.S. company is one of the owners of CanCo, and is, therefore, a shareholder of CanCo for Canadian tax purposes but a partner of CanCo for U.S. tax purposes. In the example, CanCo makes a payment to its U.S. owner that is treated as a dividend for Canadian tax purposes but which is viewed as a partnership distribution for U.S. tax purposes. The Technical Explanation provides that subparagraph 7(b) applies to preclude treaty benefits with respect to the payment because the U.S. tax treatment of the payment (as a partnership distribution) is different than it would be if CanCo were treated as a corporation for U.S. tax purposes (as a dividend).

Unlike the examples pertaining to disregarded entities, however, the Technical Explanation does not provide any example of a similar payment by a U.S. domestic reverse hybrid entity that is treated as a partnership for Canadian tax purposes to one of its owners. Although the partnership example in the Technical Explanation should apply reciprocally to a payment treated as a dividend for U.S. tax purposes and a partnership distribution for Canadian tax purposes, the Technical Explanation does not so state.

More importantly, the Technical Explanation does not provide any examples relating to a deductible interest (or royalty) payment from a hybrid partnership entity to one of its owners. In the case of such a payment from a Canadian hybrid partnership entity, the U.S. recipient of the payment would generally treat it as a payment of interest (or royalties) for U.S. tax purposes.¹⁰⁴ One might expect that subparagraph 7(b) would not apply in this case because the fiscal transparency of the partnership would generally not be relevant for residence-country tax purposes. There is no discussion of this case in the Technical Explanation, however. It is also

¹⁰⁴ Under section 707(a) and Treas. Reg. section 1.707-1(a), if a partner engages in a transaction with a partnership other than in the capacity as a member of the partnership, the transaction is, in general, considered as occurring between the partnership and one who is not a partner. See Rev. Rul. 73-301, 1973-2 C.B. 215.

not clear whether subparagraph 7(b) applies with respect to deductible payments by a domestic reverse hybrid partnership entity to one of its Canadian owners. Thus, it is uncertain whether the treaty partners have “explicitly agreed ... in the text of an income tax treaty” to override the rules of Treas. Reg. section 1.894-1(d)(ii)(A), described above, as required by Treas. Reg. section 1.894-1(d)(4).¹⁰⁵

The Committee may wish to inquire regarding the treatment under subparagraph 7(b) of both deductible and nondeductible payments made by such partnerships to their owners.

¹⁰⁵ From a tax perspective, a majority owner may derive much the same result from income earned by a partnership owned in a 99-percent to 1-percent ratio as from a disregarded entity. A partnership owned by related parties may also mimic the tax results of a disregarded entity. It is unclear what policy rationale would prescribe disparate treatment under subparagraph 7(b) with respect to partnerships and disregarded entities.

C. Arbitration

Background

Like other U.S. income tax treaties, the existing treaty includes a mutual agreement procedure. The mutual agreement procedure allows taxpayers to bring to the attention of the competent authorities problems under the treaty, and it authorizes the competent authorities of the two countries to cooperate to resolve disputes, clarify issues, and address cases of double taxation not provided for in the treaty. Under the existing treaty, a case that the competent authorities are unable to resolve may be submitted to voluntary arbitration if the competent authorities and the affected taxpayer agree to arbitration. Article 21 of the proposed protocol replaces this optional arbitration provision with rules for mandatory binding arbitration of certain cases about which the competent authorities cannot reach a negotiated agreement. The rules governing the process and substance of the arbitration are described in detail above in Section V.

Tax treaties traditionally have not included a mechanism to ensure resolution of disputes, and the voluntary binding arbitration procedures described above have never been invoked in any U.S. mutual agreement procedure. Moreover, in the case of the United States, the average processing time on closed competent authority cases may approach or exceed two years,¹⁰⁶ and some observers believe that a significant number of cases simply are never resolved. As a consequence, many commentators as well as participants in the competent authority process have expressed the view that the traditional mutual agreement procedure often does not fulfill its stated objective of providing relief from double taxation. Proponents of mandatory arbitration believe that incorporating into the mutual agreement process a mechanism that would ensure the resolution of disputes would address this problem, for two reasons. First, disputes that could not be resolved by the competent authorities within a prescribed time frame would be finally and completely resolved through the arbitration process. More fundamentally, however, proponents argue that the existence of a mandatory arbitration process will impel the competent authorities to reach mutual agreement, so as to avoid any arbitration proceedings. This argument is premised on the belief that the competent authorities would prefer to negotiate their own settlement to having an outcome imposed by an arbitration board. Proponents further believe that, if a competent authority believes that an arbitration board may determine the matter adversely to that competent authority, mutual agreement on reasonable and moderate grounds will be more likely. These proponents hold the view, therefore, that while few, if any, actual arbitrations will occur, many more cases will be resolved promptly and appropriately through the mutual agreement procedure. On the other hand, some commentators have argued that there is no evidence to date that the existence of mandatory arbitration changes the negotiating posture of the competent authorities.

If the proposed protocol enters into force, the U.S.-Canada treaty will be the third bilateral U.S. income tax treaty to provide mandatory binding arbitration of unresolved cases.

¹⁰⁶ See *Internal Revenue Service, Deputy Commissioner (International), Large and Mid-Size Business Division, Competent Authority Statistics*, that has been prepared and presented annually by the IRS at the Annual Institute on Current Issues in International Taxation.

Similar arbitration provisions in the U.S. treaties with Belgium and Germany took effect at the beginning of this year. The staff of the Joint Committee on Taxation has provided detailed analyses of those arbitration provisions,¹⁰⁷ including the “last best offer” or “final offer” arbitration methodology adopted in the treaties with Belgium and Germany, as well as in the proposed protocol with Canada.¹⁰⁸ Those analyses also include descriptions of mandatory arbitration procedures adopted in the OECD Model treaty and by the European Union. The following is a more limited discussion of certain key features of the arbitration provision of the proposed protocol that differ in some way from the analogous provisions in either or both of the treaties with Belgium and Germany.

The discussion below concerns particular features of the arbitration provision of the proposed protocol. More generally, the Committee may wish to ask about the Treasury Department’s intentions for future U.S. income tax treaties and protocols. Does the Treasury Department expect that mandatory arbitration provisions following the framework of the provision in the proposed protocol and in the treaties with Belgium and Germany will become a standard feature of future U.S. treaties, or will the Treasury Department be more selective in choosing the countries with which it negotiates such provisions? If mandatory arbitration is not expected to be part of all future U.S. income tax treaties, it may be useful to ask how the Treasury Department will decide whether a particular treaty should include mandatory binding arbitration.

Scope

In general, a case may be resolved through arbitration under the proposed protocol and the accompanying diplomatic notes only if it involves the application of one or more of the following articles of the treaty (and is not a particular case that the competent authorities agree is not suitable for determination by arbitration): Article IV (Residence), but only to the extent the case relates to the residence of natural persons; Article V (Permanent Establishment); Article VII (Business Profits); Article IX (Related Persons), and Article XII (Royalties), but only to the extent the case relates (1) to the application of Article XII to transactions involving related persons or (2) to an allocation of amounts between taxable and non-taxable royalties. These are the same articles that may be the subject of arbitration cases under the U.S.-Germany treaty. The U.S.-Belgium treaty, by contrast, provides for binding arbitration of a case involving the application of any article of the treaty (so long as the competent authorities have not agreed that the particular case is not suitable for arbitration).

¹⁰⁷ See Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Belgium* (JCX-45-07), July 13, 2007; Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Germany* (JCX-47-07), July 13, 2007.

¹⁰⁸ In “last best offer” or “final offer” arbitration, each of the parties proposes one and only one figure for settlement, and the arbitrator must select one of those figures as the award. The methodology is intended to encourage the competent authorities not to assert unreasonable claims.

The Committee may wish to consider whether the scope of mandatory arbitration in the proposed protocol is appropriate. In particular, it may wish to inquire about the criteria the Treasury Department has used in determining to which treaty articles mandatory arbitration should apply. For example, should mandatory arbitration be used only for articles that have given rise to cases that historically have been difficult to resolve under the mutual agreement procedure? The Committee also may wish to consider the basis for the rule included in the proposed protocol and in the treaties with Belgium and Germany permitting the competent authorities to agree that a particular case is not suitable for arbitration. It is unclear what factors the competent authorities will take into account in deciding that a particular case is or is not suitable for arbitration. Granting broad discretion to the competent authorities in making such a decision may help facilitate agreements in individual cases, but it also is possible that a lack of explicit factors for deciding which cases may go to arbitration could create unpredictability for taxpayers and undermine the efficacy of the mandatory arbitration procedure.

Precedent

Like the treaties with Belgium and Germany, the proposed protocol provides that the arbitration board will limit its determination to stating an amount of income, expense, or tax reportable to the treaty countries. The determination will not state a rationale and will have no precedential value. Arbitration board determinations under the treaties with Belgium and Germany also will not include rationales and will have no precedential value. By contrast with the proposed protocol and the treaty with Belgium, however, the treaty with Germany includes (in the diplomatic notes) a statement that although decisions of the arbitration board do not have precedential effect, it is expected that decisions ordinarily will be taken into account in subsequent competent authority cases involving the same taxpayer, the same issue, and substantially similar facts, and may also be taken into account in other cases where appropriate.

The requirement that the arbitration board not provide a rationale appears to follow from the “last best offer” structure of the arbitration process.¹⁰⁹ The arbitration board must choose one of the two proposals submitted to it by the competent authorities without modification. As a result, the arbitration board’s decision does not necessarily represent the independent view of the board as to the “right” answer, but rather its decision as to which of the two offers is the least wrong. It has been suggested that a reasoned decision in these circumstances would be less helpful than it might be in a case in which the arbitration board is permitted or required to reach its own conclusion as to how to resolve a matter. The Committee may wish to inquire, however, into the possible significance of the proposed protocol’s omission of any statement that arbitration board decisions should be taken into account in certain similar subsequent cases. Does the omission of such a statement mean that, unlike under the treaty with Germany, under the proposed protocol an arbitration board decision will have no consequence at all for future determinations?

¹⁰⁹ The advantages and disadvantages of the “last best offer” approach are discussed generally in Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Belgium* (JCX-45-07), July 13, 2007; Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Germany* (JCX-47-07), July 13, 2007.

Legal authorities

The notes to the proposed protocol provides that in making its determination, an arbitration board must apply as necessary the following legal authorities: (1) the provisions of the treaty; (2) any agreed commentaries or explanations of the treaty countries concerning the treaty; (3) the laws of the United States and Canada to the extent they are not inconsistent with each other; and (4) any OECD Commentary, Guidelines, or Reports regarding relevant analogous portions of the OECD Model treaty. This rule is similar to rules in the treaties with Belgium and Germany. Unlike the proposed protocol, however, those treaties include the additional statement that the authorities that are to be applied are to be given priority in accordance with the order in which they are listed. Thus, for instance, the provisions of those treaties are to be given greater weight than OECD Commentary. The Committee may wish to ask whether it is intended that arbitration boards under the U.S.-Canada treaty have maximum flexibility in deciding how much weight to accord the various sources of authority, including giving greater priority to relevant OECD Commentary, Guidelines, or Reports than to the provisions of the treaty or the Technical Explanation. Flexibility may promote resolution of disputes, but it also may contribute to taxpayers' uncertainty about how an arbitration board might make a determination.

The proposed protocol and the treaties with Belgium and Germany include as one authority for board determinations any agreed commentaries or explanations of the treaty countries concerning the treaty. This rule may have different implications for the proposed protocol than it does for the treaties with Belgium and Germany. For those latter treaties, the Treasury Department produced its own technical explanations; those explanations were not agreed to by Belgium or Germany. The Technical Explanation of the proposed protocol, by contrast, states: "The Technical Explanation is an official United States guide to the Protocol. The Government of Canada has reviewed this document and subscribes to its contents." It seems clear, therefore, that the Technical Explanation of the proposed protocol is an "agreed . . . explanation[]" that will serve as authority for arbitration board determinations. It is less clear whether documents other than the Technical Explanation might qualify as "agreed commentar[y] or explanation[]." Is it possible, for instance, that an agreement of the competent authorities concerning a particular matter of treaty interpretation would qualify? The Committee may wish to ask for clarification of this issue.

Our understanding is that there are a number of competent authority cases pending between the United States and Canada, both in number and in dollar value, and that, historically, a substantial number of double taxation cases have not been satisfactorily resolved by the U.S. and Canadian competent authorities. The Department of the Treasury does not release statistics that reflect competent authority activities by individual treaty partners. While many expect that the proposed mandatory and binding arbitration procedures will be successful in resolving recurring issues and will encourage the competent authorities to settle cases without resort to arbitration, it will take time to ascertain if these procedures are effective or if unexpected problems arise. Meanwhile, the Treasury Department or other trading partners may seek to negotiate treaty provisions with current or future treaty partners that are similar, in whole or in part, to the arbitration procedures of the proposed protocol. The Committee may wish to better understand how the Treasury Department intends to monitor the competent authority function, as well as arbitration developments with respect to other countries, to determine the overall effects

of the new arbitration procedures on the mutual agreement process. The Committee may wish to consider what types of information are needed to measure whether, regardless of whether they are utilized, the proposed arbitration procedures result in more efficient case resolution, both before and during arbitration, and whether they enhance the quality of the outcome of the competent authority cases.

In general, arbitration proceedings under the proposed protocol begin on the later of (1) two years after the commencement date of a case, and (2) the earliest date upon which all concerned persons have entered into a confidentiality agreement and the agreements have been received by both competent authorities. The commencement date for a case is the earliest date on which the information necessary to undertake substantive consideration for a mutual agreement has been received by both competent authorities. Article 27, paragraph 3(f) of the proposed protocol provides that the commencement date for a case that is under consideration by the competent authorities on the date on which the proposed protocol enters into force will be the date that the proposed protocol enters into force. This provision implies that (1) cases pending in the competent authority process at the time the proposed protocol enters into force will be eligible for arbitration (provided the other requirements for arbitration are met), and (2) no more than two years will pass from the entry of the protocol into force until arbitration proceedings may begin for such a pending case. However, the competent authorities may provide for a shorter period of time for pending cases than two years from the date that the proposed protocol enters into force. The Committee may wish to confirm with the Treasury Department this understanding of the application of the proposed protocol with respect to pending cases and inquire regarding shortening of the two-year period.

D. Technical Explanation

The Treasury Department is responsible for (1) negotiating income tax treaties, (2) providing an explanation of such treaties to the U.S. Senate, and (3) implementing such treaties for U.S. tax purposes. The explanation provided by the Treasury Department is set forth in a “technical explanation,” which describes and analyzes the proposed treaty, section-by-section. The technical explanation is submitted to the U.S. Senate, together with the proposed treaty under consideration. The Treasury Department follows the same procedures with respect to negotiating, explaining, and implementing protocols to existing income tax treaties.¹¹⁰

A Treasury technical explanation to a treaty that has entered into force is considered by the Treasury Department as an official U.S. guide to that treaty. Typically, the technical explanation is prepared by the Treasury Department without any express input or endorsement by the other treaty country.

The present income tax treaty between the United States and Canada was originally signed on September 26, 1980, and has since been amended by protocols concluded on June 14, 1983, March 28, 1994, March 17, 1995, and July 29, 1997. The Treasury Department prepared a corresponding technical explanation for the original treaty and each of the protocols. On several occasions, the Canadian Government has taken the unusual step of endorsing the Treasury technical explanation.¹¹¹

In the case of the Technical Explanation prepared by the Treasury Department with respect to the proposed protocol, the Canadian Government reviewed and subscribed to the contents of the Technical Explanation. This concurrence is referenced by the Treasury Department in the Introduction to the Technical Explanation, which notes that, in the view of both treaty countries, the Technical Explanation “reflects the policies behind particular Protocol

¹¹⁰ For simplicity, treaties and protocols (proposed and in-force) are collectively referred to as “treaties” for purposes of this section.

¹¹¹ “In accordance with its usual practice, the U.S. Treasury has prepared a technical explanation of the Protocol. While it is not customary in Canada to issue such an explanation, an opportunity was given to members of the delegation representing Canada in the negotiations to review and comment on the U.S. Treasury’s explanation. The Minister indicated that Canada agrees that the technical explanation accurately reflects understandings reached in the course of negotiations with respect to interpretation and application of the various provisions of the Protocol.” Press Release 1997-122, Canada Department of Finance (Dec. 18, 1997) (regarding the announcement by Canadian Finance Minister Paul Martin that the Protocol signed on July 29, 1997, amending the 1980 Convention between Canada and the United States regarding taxes on income and capital, entered into force on December 16, 1997); see also Press Release 1995-048, Canada Department of Finance (June 13, 1995) (regarding the technical explanation released by the U.S. Treasury Department with respect to the March 17, 1995 Protocol, amending the 1980 Convention between Canada and the United States regarding taxes on income and capital, as amended by Protocols signed on June 14, 1983, and March 28, 1984); Press Release 1984-128, Canada Department of Finance (Aug. 16, 1984) (regarding the technical explanation released by the U.S. Treasury Department on April 26, 1984, with respect to the 1980 Convention between Canada and the United States regarding taxes on income and capital, which superseded the technical explanation issued on January 19, 1981).

provisions, as well as understandings reached with respect to the application and interpretation of the Protocol and the Convention.”¹¹² To achieve this concurrence, the Treasury Department submitted multiple drafts of the Technical Explanation for review, and ultimately met with, the Canadian Government to negotiate mutually acceptable descriptions. To date, this concurrence has been expressed only to the Treasury Department, but it is expected that, consistent with prior practice, a public press release from the Canadian Government will be forthcoming upon publication of the Technical Explanation.

It is not yet clear to what extent the direct involvement of the Canadian Government in the drafting of the Technical Explanation, and the Canadian Government’s explicit subscription to its contents, will affect the weight of authority afforded to the Technical Explanation. The IRS can be expected to rely on the Technical Explanation in implementing the treaty, as it has done with other Treasury technical explanations.¹¹³ In general, however, U.S. courts have not universally embraced IRS arguments based on the Treasury technical explanations.¹¹⁴ In cases in which courts have rejected attempts to rely on a technical explanation, they have cited evidence casting doubt on whether the technical explanation expressed the mutual intent of the treaty countries and suggesting instead that it was a unilateral view of the United States.¹¹⁵

It may be more likely that a court would view the Technical Explanation as expressing the mutual intent of both treaty countries if (1) the Technical Explanation is expressly endorsed by the Canadian Government, such as through the issuance of a press release, and (2) the U.S. Senate fully embraces all aspects of the Technical Explanation during the ratification process.¹¹⁶

¹¹² Technical Explanation at 1.

¹¹³ See, e.g., Rev. Rul. 89-95, 1989-2 C.B. 131; Rev. Rul. 81-78, 1981-1 C.B. 604.

¹¹⁴ See, e.g., *Snap-On Tools, Inc. v. United States*, 26 Cl. Ct. 1045, 1075 (1992) (“[T]he Executive Branch should not be allowed to amend a [sic] treaty on which the treaty is silent by suggesting changes in the Technical Explanation.”), *aff’d mem.*, 26 F.3d 137 (Fed. Cir. 1994); *Xerox Corp. v. United States*, 41 F.3d 647, 655-56 (1994) (“[O]ne may debate the meaning of this cool treatment [by the Senate] of the Technical Explanation. What is clear, however, is that the Treasury’s position was not embraced by the Senate.”).

¹¹⁵ See, e.g., *Xerox Corp.*, 41 F.3d at 656 (“Both of the United Kingdom’s Ministers for the Treasury averred that they did not accept, or even know of, the position taken in the Technical Explanation.”); see also *Snap-On Tools, Inc.*, 26 Cl. Ct. at 1072 (“An understanding of a position which forms the basis for a negotiated international agreement cannot be arrived at ‘tacitly,’ but must be achieved consciously and deliberately by both parties.”).

¹¹⁶ In *Xerox Corp.*, the court perceived that the Senate had distanced itself from part of the Treasury technical explanation at issue. A renegotiated tax treaty was signed on December 31, 1975, between the United Kingdom and the United States, and amended by diplomatic notes on April 13, 1976, First Protocol of August 26, 1976, Second Protocol of March 31, 1977, and Third Protocol of March 15, 1979, which together comprise the Convention Between the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation on the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains. In 1977, the Treasury Department issued a technical explanation in conjunction with the ratification procedures for the Second Protocol (the “U.K. TE”). The U.K. TE contained complex rules and examples

In the absence of an express endorsement by the Canadian Government, Senate support for the Technical Explanation clearly would not be sufficient to establish the mutual intent of the treaty partners.¹¹⁷ On the other hand, the absence of Senate support could undermine the status of the Technical Explanation as a mutual agreement, even if the Technical Explanation is expressly endorsed by the Canadian Government.

If the Canadian Government and the Senate both favorably embrace the Technical Explanation, U.S. courts may also find it persuasive that at least one Canadian court has relied on a Treasury technical explanation, based on Canada's representation that it accurately reflected the understandings reached during negotiation of the 1983 Protocol.¹¹⁸

Given the lack of deference shown by U.S. courts in cases in which a technical explanation is viewed as unilateral in nature, the Committee may wish to inquire whether Treasury intends to pursue agreed technical explanations in future negotiations with other treaty partners.

Further, the diplomatic notes exchanged in conjunction with the proposed protocol include "agreed commentaries or explanations of the Contracting States" in the list of the types of authorities that an arbitration board may apply in making a determination under paragraph 6 of Article XXVI (Mutual Agreement Procedure) of the treaty, as amended. The Committee may also wish to inquire whether the Treasury Department views the Technical Explanation as an agreed commentary or explanation for purposes of arbitration proceedings.

for purposes of calculating U.S. indirect foreign tax credits under the U.K. Advance Corporation Tax ("ACT") regime. The Senate Executive Report noted that "in recommending the ratification of the proposed treaty, the Committee does not intend to accept or reject the amplifications of the foreign tax credit rules contained in the Treasury technical explanation." S. Exec. Rep. No. 95-18, at 36-37 (1978), *reprinted in* 1980-1 C.B. 411, 429. In the view of the *Xerox Corp.* court, the Senate Executive Report had "criticized" Treasury's approach to handling the issue of U.S. indirect foreign tax credits under the U.K. ACT regime by addressing it in the U.K. TE, and concluded that "Treasury's position was not embraced by the Senate." *Xerox Corp.*, 41 F.3d at 655-56.

¹¹⁷ See, e.g., *National Westminster Bank, PLC v. United States*, 58 Fed. Cl. 491, 499 (2003) (referring to both the U.K. TE and the Senate Executive Report, noting that "even if the court were to read [both of] these statements more broadly, the unilateral views of the U.S. are not controlling. . . . the court must give meaning to the intent of the treaty partners, not simply the views of the U.S."), *aff'd*, 512 F.3d 1347 (2008).

¹¹⁸ See *Coblentz v. Canada* (C.A.) (1996), [1997] 1 F.C. 368 (Sept. 30, 1996).