
Policy Forum: The Fifth Protocol to the Canada-US Income Tax Treaty and the 2006 US Model Treaty—How Do They Compare?

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ABSTRACT

The US model income tax convention is intended in part to be a starting point for US tax treaty negotiations; however, it does not include all provisions to which the United States has agreed in more recent tax treaties, nor have actual negotiations necessarily resulted in treaties or protocols that follow the model in all respects. In this article, the authors compare the Canada-US income tax treaty, as it will be modified by the fifth protocol to the Canada-US income tax treaty, signed in September 2007, with the US model income tax convention, and comment on the differences between the two texts. The authors discuss the implications and significance of the changes brought about by the protocol and the extent to which they conform with the US model convention as well as other recent US tax treaties.

KEYWORDS: CANADA-US ■ TAX TREATIES ■ MODELS ■ FOREIGN TAXES ■ WITHHOLDING TAXES ■ FOREIGN INVESTMENT

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The US model income tax convention (last revised and reissued in November 2006)¹ is intended in part to be a starting point for US tax treaty negotiations, but it does not include all provisions to which the United States has agreed in more recent tax treaties, nor have actual negotiations necessarily resulted in treaties or protocols that follow the model in all respects. How, then, does the fifth protocol² to the Canada-US treaty,³ signed in September 2007, measure up? This is the subject of our article.

The discussion that follows (which is not intended to be exhaustive) generally follows the sequence of articles in the Canada-US treaty as they would be changed by the protocol. Because the expected joint technical explanation of the protocol has not yet been issued, our comments are qualified by its absence.

TAXES COVERED

The US taxes covered by the treaty, as it would be modified by the protocol, do not include the US excise tax imposed on premiums paid for the insurance or reinsurance of US risks by foreign insurers that do not carry on business in the United States through a branch or other permanent establishment.⁴ Nor does the US model treaty include the excise tax, but treaty coverage (and thus the elimination) of the excise tax is a feature of a number of US tax treaties, including those with Japan, Ireland, Finland, France, and Germany. The absence of coverage may reflect the lack of consensus in the United States on whether foreign insurance companies are being taxed appropriately on the income from insurance or reinsurance of US risks.

RESIDENCE

Under the protocol, a corporation created under the laws of one state is a resident of that state. If created under the laws of both states or otherwise not covered by this rule, the corporation's residence is determined by agreement between the competent authorities; and, failing such agreement, the corporation is considered not to

1 United States, Department of the Treasury, United States Model Income Tax Convention of November 15, 2006 (herein referred to as "the US model treaty").

2 Protocol Amending the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital Done at Washington on 26 September 1980, as Amended by the Protocols Done on 14 June 1983, 28 March 1984, 17 March 1995 and 29 July 1997, signed at Meech Lake, Quebec on September 21, 2007 (herein referred to as "the protocol"). Canada ratified the protocol on December 14, 2007; the United States had not yet done so as at the date of this article.

3 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997 (herein referred to as "the Canada-US treaty" or "the treaty").

4 The excise tax is imposed by sections 1471-1474 of the Internal Revenue Code of 1986, as amended. Article II(2)(b) of the treaty lists the US taxes that are covered by the treaty.

be a resident of either state. This brings the determination of corporate residence into line with the US model treaty.⁵

While the treaty, as it will be changed by the protocol, does address in some detail the treatment of income earned by so-called fiscally transparent entities, it does so in language that differs from that in article 1(6) of the US model treaty.⁶ With respect to US tax, the model treaty simply confirms what is already provided in the regulations issued under section 894 of the Internal Revenue Code in the case of interest, dividends, royalties, and other “fixed or determinable annual or periodical” income (or, generally, investment income)⁷ and extends the denial of treaty benefits to income of a fiscally transparent entity that is not “fixed or determinable annual or periodical,” such as income derived through a branch. There are at least two possible differences under the protocol. First, new article IV(7)(b) of the treaty denies Canadian owners of the equity in a reverse domestic hybrid (an entity that is not fiscally transparent in the United States but is in Canada) the benefit of the reduction in the withholding tax on dividends that would otherwise be available under the section 894 regulations.⁸ Second, it is not as clear that the changes made by the protocol will deny treaty benefits in respect of income of a Canadian entity that is not “fixed or determinable annual or periodical”—for example, that a Canadian entity that operates in the United States through a fiscally transparent entity will be denied the benefits of the permanent establishment article.

PERMANENT ESTABLISHMENT

Like the US model, the protocol treats income from independent personal services as business profits that may or may not be attributable to a permanent establishment. Thus, it eliminates the separate article in the existing treaty that deals with such services.⁹

In other respects, the definition of a permanent establishment is substantially the same in the US model as in the treaty,¹⁰ except that the protocol adds a new rule in

5 The treaty (and protocol) notwithstanding, the United States may treat a corporation organized under Canadian law as a US corporation for tax purposes if the shares of the corporation are stapled to the shares of a US corporation or the corporation is an “expatriated” US corporation covered by section 7874 of the Internal Revenue Code.

6 The US model treaty language provides (in article 1(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.”

7 Treas. reg. section 1.894-1(d).

8 Treas. reg. section 1.894-1(d)(2)(B)(1)(iii). More precisely, new article IV(7)(b) denies any treaty benefit with respect to income paid by such an entity that is treated differently than it would be if the entity were not fiscally transparent in the state of the recipient.

9 Article XIV of the treaty, eliminated by article 9 of the protocol.

10 There are some other differences; for example, the US model would treat an installation or drilling rig or ship as a permanent establishment only if it was present in the state for more than 12 months, not more than 3 months in any 12-month period, as under the treaty.

article v(9). Where an enterprise provides services in the “source” state,¹¹ but does not otherwise have a permanent establishment in that state, the provision of services will be treated as a permanent establishment if more than half of the business revenues of the enterprise are derived from services performed by an individual who is present in the state for 183 days or more during any 12-month period, or if the services are provided with respect to a “project” conducted by the enterprise in the source state and certain other conditions are met.¹²

Will the rule added by the protocol change the US tax treatment of independent services performed by a Canadian resident in the United States? Absent any treaty, the performance of services in the United States by a Canadian resident would be a trade or business carried on in the United States, and the income from the services would be subject to US tax.¹³ Under the US model treaty, this would be so only if there was a “fixed place of business” to which the income was attributable. With the change to the definition of a permanent establishment in the protocol, income from independent services performed in the United States may become subject to US tax in the absence of a fixed place of business. The difference between the model and the protocol could therefore be important to Canadian residents in particular cases.

BUSINESS PROFITS

Like the US model treaty, the protocol attributes to a permanent establishment the business profits that it would be expected to earn if it were a separate entity dealing at arm’s length with the rest of the enterprise (as well as related persons). In related diplomatic notes,¹⁴ the United States and Canada have agreed that the principles of the OECD transfer-pricing guidelines¹⁵ will apply in determining what is attributable.¹⁶

With respect to US tax, although the effect of this change (being largely reflected in the diplomatic notes) is not entirely clear, it could be dramatic for banks and other Canadian enterprises that carry on business through branches or other permanent establishments in the United States. Although not entirely clear, the existing treaty does not go so far as to replace the “effectively connected” rules that the United States

11 We use “source” state in this article to refer to the state that is the source of the income as distinguished from the state in which the taxpayer is resident.

12 The services with respect to the project or a “connected” project (which together “constitute a coherent whole, commercially and geographically”) must be provided for “customers” who are residents of the source state or who maintain a permanent establishment in that state; and the services must be provided for 183 days or more in any 12-month period.

13 Sections 861(a)(3) and 864(b) of the Internal Revenue Code.

14 See paragraph 9 of annex B accompanying the protocol.

15 Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD) (looseleaf).

16 The separate entity concept derives from the OECD’s work on transfer pricing, the most recent results of which are presented in Organisation for Economic Co-operation and Development, *Report on the Attribution of Profits to Permanent Establishments: Parts I (General Considerations), II (Banks) and III (Global Trading)* (Paris: OECD, December 2006).

uses to determine the gross income of a branch or other permanent establishment, and the allocation and apportionment rules that it uses to determine the deductible expenses of the branch. The OECD transfer-pricing guidelines would clearly replace those rules and use arm's-length pricing methods to determine the taxable income of a branch. It is also likely that the United States will interpret this change as requiring "consistency"—that is, as requiring Canadian enterprises that operate in the United States through branches or other permanent establishments to choose on an all-or-nothing basis between the permanent establishment article in the treaty and the Internal Revenue Code (thus, for example, preventing a Canadian enterprise that relies on the permanent establishment article from simultaneously using the safe harbour rules in the Internal Revenue Code with respect to trading in stocks, securities and commodities).¹⁷

The same diplomatic notes provide, as does the US model, that the portion of the overall investment income of an insurance company from reserves and surplus that is attributable to a branch is the portion that supports the risks assumed by the branch. Presumably, this means that the United States cannot determine the investment income of a Canadian insurance company with a US branch by applying the formulary rule set out in section 842(b) of the Internal Revenue Code, as opposed to the specific facts; in other words, the protocol confirms the US Tax Court decision in *North West Life Assurance Co. of Canada*.¹⁸ Additionally, the protocol, in common with the US model, provides that a bank or other financial institution may attribute capital to each of its offices by allocating equity on the basis of the proportion of the risk-weighted assets attributable to each office. Risk weighting would partially displace the formulary calculation of the deductible interest expense of a US branch that is set out in reg. section 1.882-5 (and the corresponding calculation of "net equity" for purposes of the US branch profits tax).

INTEREST

Like the US model treaty, the protocol eliminates withholding tax on interest, other than "contingent interest"; but, unlike the model, it does so only over a phase-in period.¹⁹

With respect to US tax, this change is significant mainly for the treatment of interest paid by a US corporation or partnership to a 10 percent or greater direct or indirect shareholder, or partner, since most other US-source interest is already exempt

17 Application of the safe harbour rules would mean that gains from trading in stocks, securities, and certain commodities would not constitute a US trade or business even if conducted by a US office of a foreign person (assuming that the foreign person was not a dealer).

18 107 TC 363 (1996).

19 Presumably in anticipation of the elimination of withholding tax on interest paid to residents of the United States, a proposed amendment to domestic Canadian tax legislation will remove such tax on all interest paid after January 1, 2008 to arm's-length lenders regardless of their country of residence: Canada, Department of Finance, Budget and Economic Statement Implementation Act, 2007, SC 2007, c. 35, section 59(3).

from US withholding tax as “portfolio interest.”²⁰ The exclusion of contingent interest,²¹ which will be subject to a 15 percent withholding tax, is consistent with the exclusion of such interest in the US model treaty, which in turn derives from the exclusion from the definition of portfolio interest that was added to the Internal Revenue Code in 1993.²² The definition of contingent interest in the protocol uses substantially the same words as the Internal Revenue Code exclusion.

DIVIDENDS

Like the US model treaty, the protocol continues the rates of withholding on dividends at 15 percent generally and 5 percent in the case of a dividend paid to a 10 percent or greater corporate shareholder; but, unlike a number of more recent US tax treaties, the protocol does not reduce the rate to zero in the case of dividends paid to a corporation that owns 80 percent or more of the stock of the corporation that pays the dividend.²³ While the reduced rate is not available to all US treaty partners, it is highly unlikely that the United States would not have offered the zero rate to Canada had Canada been prepared to reciprocate in respect of dividends paid by Canadian corporations to US parent corporations. Recent US treaties also provide for a zero rate of withholding on dividends paid to pension, retirement, and like plans, which is already a feature of the Canada-US treaty.²⁴

In any event, the only change in the treatment of dividends made by the protocol (leaving aside the treatment of dividends paid by or to fiscally transparent entities)²⁵ is a modest extension, consistent with the US model treaty, of the 15 percent rate that applies to certain dividends of real estate investment trusts (REITs). The 15 percent rate is now available for such dividends if they are paid to an individual shareholder

20 As a further exception, article 6 of the protocol would eliminate withholding on interest paid to a bank on a loan pursuant to an agreement made in the ordinary course of the bank's business, thus permitting Canadian banks to issue loans from non-US offices without withholding tax.

21 The exclusion applies only to the part of the interest that is contingent (that is, does not affect any fixed portion of the interest on a loan). For this purpose, “contingent interest” is defined as interest “that is determined with reference to receipts, sales, income, profits or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor to a related person”: article XI(6)(b) of the treaty as amended by article 6 of the protocol.

22 Section 871(h)(4) of the Internal Revenue Code.

23 The 5 percent rate is also the rate of the US branch profits tax. Had the rate on parent-subsidiary dividends been reduced to zero, the rate of the branch profits tax would have been correspondingly reduced.

24 Article XXI of the treaty.

25 Article X(2)(a) of the treaty as amended by article 5 of the protocol provides that the 10 percent ownership threshold for determining eligibility for the 5 percent rate is applied by looking through entities that are fiscally transparent in the shareholder's state of residence. This is the existing rule in the regulations under section 894 of the Internal Revenue Code.

owning not more than 10 percent of the REIT, any shareholder owning not more than 5 percent of any class of the stock of the REIT if the dividend is paid on a class of stock that is publicly traded, and any shareholder owning not more than 10 percent of the REIT if the REIT is “diversified.”

ROYALTIES

Like the US model treaty, the protocol continues the zero rate of withholding for certain royalties; but, unlike the model, it continues to limit the zero rate to specified royalties (excluding, for example, motion picture or television royalties). Under the US model treaty, all royalties for intangible property are zero-rated. The protocol preserves the present 10 percent withholding tax in other cases.

DEPENDENT PERSONAL SERVICES (NOW “INCOME FROM EMPLOYMENT”)

Like the US model treaty, the protocol provides that compensation received as an employee is not subject to tax in the source state if the individual is not there for more than 183 days in a 12-month period and the compensation is not paid by a source-state enterprise, including a permanent establishment of a foreign enterprise in the source state. The protocol goes further, however, and provides for an exemption from source-state taxation if the compensation does not exceed \$10,000 a year.

ARTISTES AND ATHLETES

While the treaty generally follows the rules in the US model treaty with respect to the income of artistes and athletes, the model does not include an exception to source-state taxation for athletes employed by teams that participate in leagues with regularly scheduled games in both states. The protocol does not change the exception in the existing treaty.²⁶

EXEMPT ORGANIZATIONS

The US model treaty does not exempt the income of a foreign charitable or like organization, or of a pension, retirement, or like plan, although (as noted above) more recent US treaties provide for a zero rate on dividends received by a foreign pension, retirement, or like plan. The treaty with Canada has, of course, long provided an exemption from tax for income of such organizations, other than income from related persons.²⁷

26 Article XVI of the treaty. An exemption is provided where the athlete’s compensation does not exceed \$15,000 a year.

27 Article XXI of the treaty.

OTHER INCOME

The US model treaty does not itself refer to the treatment of guarantee fees (amounts paid in consideration of the guarantee of indebtedness), but the technical explanation states that such fees would be exempt under the “Other Income” article of the model treaty.²⁸ The protocol adds a new paragraph 4 to article XXII, specifically providing that guarantee fees are not taxable in the source state. This change no doubt reflects the fact that article XXII of the treaty, unlike the corresponding article of the model, does not assign “other income” exclusively to the state of residence of the taxpayer, but excepts “such income [if it] arises in the other Contracting State.”²⁹

LIMITATION ON BENEFITS

Like the US model treaty, the protocol continues to reflect the United States’ insistence that treaty benefits extended by the United States be subject to a limitation-on-benefits article, which is intended to prevent the use of treaties by third-country residents. The protocol makes article XXIX A reciprocal, so that it limits the extension by Canada of treaty benefits to qualifying persons (as defined). The protocol also updates the article to reflect the current US model treaty; changes made by the protocol principally relate to a rule that measures ownership.

MUTUAL AGREEMENT PROCEDURE

Unlike the US model treaty, but consistent with some recent US tax treaties—notably, the protocol with Germany and the new tax treaty with Belgium—the Canada–US protocol contemplates mandatory binding arbitration to resolve certain disputes between the competent authorities of Canada and the United States.³⁰ The US–Germany protocol and US–Belgium treaty, which preceded the Canada–US protocol, had been pending before the US Senate Committee on Foreign Relations for some time, but holds placed on these treaties were recently removed when they were ratified on December 14, 2007. It appears that one of the concerns of the committee with respect to Germany and Belgium was the lack of taxpayer participation in the binding arbitration process.³¹

28 United States, Department of the Treasury, United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, article 21.

29 Article XXII(1) of the treaty.

30 Article XXVI(6) of the treaty as amended by article 21 of the protocol.

31 Raised by Senator Menendez during the testimony of John Harrington, international tax counsel, Department of the Treasury, before the Senate foreign relations committee in July 2007. See United States Senate Committee on Foreign Relations, *Hearings Before the Committee on Foreign Relations*, 110th Cong., 1st sess., July 17, 2007.

It is, of course, a matter of public record that the Canadian and US competent authorities have struggled to resolve cases under the mutual agreement procedure (MAP) in recent years, to the point that, in 2004, the entire MAP program virtually ground to a halt. The introduction of binding arbitration in the protocol is one of a number of steps that have been taken to respond to the present-day reality that, in an increasing number of cases, the Canadian and US competent authorities are not able to agree on, and thus resolve, double taxation cases.³² Ratification of the German and Belgian protocol and treaty, and hence of the binding arbitration process, should pave the way for the Canadian protocol.

32 The need for arbitration was explained by John Harrington, *ibid.*, at 5: “[A]s the number and complexity of cross-border transactions increases, so does the number and complexity of cross-border tax disputes. Accordingly, we have considered ways to equip the U.S. competent authority with additional tools to resolve disputes promptly, including the possible use of arbitration.”