Legislative Summary **LS-614E**

BILL S-2: AN ACT TO AMEND THE CANADA–UNITED STATES TAX CONVENTION ACT, 1984

Mark Mahabir
Law and Government Division

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LEGISLATIVE HISTORY OF BILL S-2

HOUSE OF COMMONS

Bill Stage	Date
First Reading:	22 November 2007
Second Reading:	26 November 2007
Committee Report:	7 December 2007
Report Stage:	13 December 2007
Third Reading:	13 December 2007

SENATE

Bill Stage	Date
First Reading:	18 October 2007
Second Reading:	14 December 2007
Committee Report:	15 December 2007
Report Stage:	
Third Reading:	21 November 2007

Royal Assent: 14 December 2007

Statutes of Canada 2007, c. 32

N.B. Any substantive changes in this Legislative Summary that have been made since the preceding issue are indicated in **bold print.**

Legislative history by Michel Bédard

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BILL S-2: AN ACT TO AMEND THE CANADA–UNITED STATES TAX CONVENTION ACT[*]

INTRODUCTION

Bill S-2, An Act to amend the Canada–United States Tax Convention Act, 1984, was introduced in the Senate by the Leader of the Government in the Senate, the Honourable Marjory LeBreton, P.C., and received first reading on 18 October 2007. The bill received third reading in the Senate on 21 November 2007. It was introduced in the House of Commons on 22 November 2007 and was referred to the Standing Committee on International Trade on 26 November 2007. It received third reading in the House of Commons on 13 December 2007, and on 14 December 2007 received Royal Assent.[(1)]

The *Canada–United States Tax Convention Act, 1984* ratifies the current tax treaty or convention between Canada and the United States involving taxes levied by each country on income and capital (Canada–US Tax Treaty).[(2)] The main purpose of a tax treaty is to prevent double taxation by splitting the total amount of tax payable between two jurisdictions according to the residency of the individual or the location of the income being generated. To achieve this purpose, a treaty will contain general rules which work in tandem with domestic tax legislation. The amount of tax payable in each jurisdiction is usually unequal due to tax rate disparities. There is growing awareness in the international tax community that at least one country should be able to tax an item of income and this should be one of the goals in coordinating national tax laws through tax treaties.[(3)] Tax treaties also aim to simplify compliance with two national taxation systems and try to prevent tax evasion.[(4)]

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* Notice: For clarity of exposition, the legislative proposals set out in the bill described in this Legislative Summary are stated as if they had already been adopted or were in force. It is important to note, however, that bills may be amended during their consideration by the House of Commons and Senate, and have no force or effect unless and until they are passed by both houses of Parliament, receive Royal Assent, and come into force.

(1) S.C. 2007, c. 32.

(2) The tax treaty contains the agreed-upon interpretation of the treaty and the text of the convention.

(3) See Jinyan Li et al., *International Taxation in Canada*, LexisNexis, Markham, 2006, p. 12.

(4) *Crown Forest Industries Ltd.* v. *Canada* [Crown Forest], [1995] 2 S.C.R. 802.

Two model tax treaties have been developed to aid in the standardization of bilateral tax treaties – the Organisation for Economic Cooperation and Development Model Tax Convention (the "OECD model") and the United Nations Model Double Taxation Convention (the "UN model").[(5)] The OECD model predates the UN model and is primarily used for bilateral treaties between developed nations. The UN model, on the other hand, is used for agreements between developing and developed nations. The Canada–US Tax Treaty is a hybrid treaty that does not completely follow either the OECD or UN model, but is instead based on the "U.S. model treaty" and portions of the OECD model.[(6)]

Canada's first comprehensive tax treaty or convention with the United States was concluded in 1942, expanding on a more summary agreement first entered into in 1928.[(7)] The 1942 agreement was overhauled, modernized and replaced by a new comprehensive treaty in 1980.[(8)] Since 1980 the treaty has been amended, upgraded and fine-tuned by protocols on four occasions, namely in 1983, 1984, 1995 and 1997.

Bill S-2 contains the fifth amending protocol ("fifth protocol"). Its purpose is to implement in Canada the fifth such protocol together with two exchanges of diplomatic notes which deal with very technical issues. The fifth protocol was concluded after nearly 10 years of negotiations aimed at modernizing and improving the 1980 convention for the betterment of individuals, families and business on both sides of the border.[(9)]

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(5) For a comparison of the two types of treaties see Bart Kosters, "The United Nations Model Tax Convention and Its Recent Developments," *Asia-Pacific Tax Bulletin*, January/February, 2004, pp. 4-11.

(6) The US model treaty contains specific provisions regarding pensions that are not found in the OECD model. For a comparison of the US model treaty and the OECD model, see United States, Department of the Treasury, Tax Treaty Documents, *United States Model Income Tax Convention: September 20, 1996*, *Technical Explanation*, Washington, DC, September 1996, http://www.treas.gov/offices/tax-policy/library/techxpln.pdf.

(7) Senate, *Debates*, 2nd Session, 39th Parliament, 24 October 2007, p. 72, http://www.parl.gc.ca/39/2/parlbus/chambus/senate/DEB-E/005db_2007-10-24-e.htm?Language=E&Parl=39 &Ses=2#27. The 1942 Convention is formally called the Convention and Protocol between Canada and the United States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion in the case of Income Taxes and was signed at Washington on 4 March 1942. The 1942 Convention was amended in 1950, 1956 and in 1966.

(8) S.C. 1984, c. 20, Part I, unofficial version at http://www.fin.gc.ca/treaties/USA_e.html.

(9) Senate (24 October 2007).

A unique feature of tax treaty ratification is that it represents the culmination of previous negotiations between two nations. Therefore, the resulting treaty is not subject to amendment by the normal process in Parliament.(10) In the US, the fifth protocol is currently being examined in Congress by the Joint Committee on Taxation and is expected to be ratified by the end of 2008.(11)

DESCRIPTION AND ANALYSIS

A. Clauses 1 to 5

Due to the unique character of the tax treaty ratification process, clauses 3 and 4 of the bill merely import the two schedules described below by adding them as a schedule to the existing *Canada–United States Tax Convention Act, 1984* ("Act"). Clause 1 changes the definition of "convention" in the existing Act to include the additional schedules. Clause 2 amends the existing convention to change the notification requirements of the minister of Finance: now, in addition to requiring that the minister publish notification in the *Canada Gazette* of the convention's entry into force, the new legislation obligates the minister to publish notification of the termination of the convention. The notifications must be published within 60 days of the entry into force or the termination of the convention. Similarly, clause 5 contains a requirement that, within 60 days of the entry into force of the two new schedules, notice of this occurrence must be published.

B. Schedules 1 and 2 (Fifth Protocol)

The bulk of the bill consists of two schedules. The first takes the form of diplomatic letters between the then Minister of Foreign Affairs and International Development, Maxime Bernier, and United States Ambassador to Canada, Terry Breese; the second contains revised or new articles to the existing treaty as agreed upon by James M. Flaherty, Minister of Finance, for the Government of Canada and Henry M. Paulson, Jr., Secretary of the Treasury, for

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(10) Senate, *Debates*, 2nd Session, 39th Parliament, 20 November 2007, p. 256 (Hon. W. David Angus), http://www.parl.gc.ca/39/2/parlbus/chambus/senate/deb-e/pdf/013db_2007-11-20-e.pdf.

(11) See KPMG Canada, "Canada–U.S. Tax Treaty Protocol – United States Kicks Off Ratification Process," 11 July 2008, http://www.kpmg.ca/en/services/tax/tnf/tnfc0821.html. For a summary of the treaty, see United States of America, Joint Committee on Taxation, "Explanation of proposed protocol to the income tax treaty between the United States and Canada," 8 July 2008, JCX-57-08, http://www.house.gov/jct/x-57-08.pdf.

the Government of the United States of America. More specifically, the first schedule outlines the procedure for coordinating and resolving tax disputes (Annex A) and the agreed upon interpretation of the amendments to the current treaty (Annex B). The second schedule contains the actual amendments to the existing tax treaty between Canada and the United States. Together, schedules 1 and 2 are called the fifth protocol.

COMMENTARY

A. Senate and House of Commons

During second reading in the Senate, debate was limited to background information on tax treaties and the evolution of the fifth protocol. At the Standing Senate Committee on Banking, Trade and Commerce, debate focused on the elimination of the withholding tax(12) for cross-border interest payments and how this elimination will aid investment in Canada by lowering the cost of borrowing for Canadian businesses. Another beneficial effect that was discussed was the anticipated increase in trade between Canada and the United States. Due to these beneficial effects, the bill was adopted by the Senate without any significant delay.

In the House of Commons, debate on the bill was limited to the over-taxation of American pensioners living in Canada when compared with pensioners living in the United States. The second pension-related issue was the prohibition of tax deductions for pension contributions made by Canadians working in the United States.(13) The fifth protocol will change this situation by allowing pension contribution deductions for Canadians who work in the US and vice versa. Concern was also voiced over the use of tax havens by large Canadian businesses to lower tax payable in Canada. Since the US is not a tax haven, the bill does not specifically address this problem. The Liberals supported the bill since it was negotiated when their party formed the government. The Bloc Québécois also approved of the bill and felt that the new mandatory arbitration procedure will help individuals unfamiliar with the current tax appeal process. Generally, all parties supported the bill at second reading in the House.

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(12) Withholding tax refers to the amount payable to the domestic tax authorities by a resident taxpayer for payments made to non-resident entities. In essence, the resident pays the amount as a tax on behalf of the non-resident entity. This amount, in practice, is usually borne solely by the resident entity since it is not usually reimbursed by the non-resident entity.

(13) House of Commons, *Debates*, 2nd Session, 39th Parliament, 26 November 2007, pp. 1350–1363, http://www2.parl.gc.ca/HousePublications/Publication.aspx?Pub=Hansard&Doc=24&Language=E&Mode=1&Parl=39&Ses=2#SOB-2219846.

At committee stage in the House of Commons, the NDP voiced concern over the lack of an economic impact analysis to determine the amount of lost tax revenue for Canada.(14) The remaining debate was similar to that which occurred in the Standing Senate Committee on Banking, Trade and Commerce, and, overall, the parties supported the bill.

B. Media

The media have been generally supportive of the bill since economists believe that it will decrease barriers to trade by eliminating the withholding tax on cross-border interest payments.(15) An indirect benefit is that the elimination of the withholding tax may also increase competition and lower lending rates in Canada. The treaty also eliminates double taxation on limited liability companies (LLCs) resident in the United States. Since American venture capital firms operate as LLCs, this change could increase the availability of funding for new Canadian businesses and technologies.(16)

C. Explanation of Technical Changes

Since this bill implements the fifth protocol and is technical fine-tuning of the existing Canada–US tax treaty, the following analysis will focus only on major changes to the treatment of income and expenses incurred by entities in Canada and the United States.(17)

1. Elimination of Withholding Tax on Interest Payments

The fifth protocol eliminates the withholding tax on cross-border interest payments. The withholding tax currently paid by Canadian entities on interest payments made to a US resident entity is 10%. This new rule eliminating the withholding tax applies only to unrelated parties or arm's-length parties (i.e., it does not apply to parent companies and their

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(14) House of Commons, Standing Committee on International Trade, *Evidence*, 2nd Session, 39th Parliament, 6 December 2007, 1550 (Peter Julian), http://cmte.parl.gc.ca/Content/HOC/committee/392/ciit/evidence/ev3192971/ciitev07-e.htm#Int-2256188.

(15) See Finn Poschmann, "Fresh tax treaty boon for investment," *National Post* [Toronto], 22 September 2007.

(16) See Kristin Goff, "Tax rules stifle venture capital: report; 'Unfavourable' climate 'should trigger alarms throughout industry and government,'" *Ottawa Citizen*, 6 December 2007.

(17) See also Arthur J. Cockfield, "Finding Silver Linings in the Storm: An Evaluation of Recent Canada–US Crossboarder Tax Developments," *C.D. Howe Institute Commentary*, No. 272, September 2008, http://www.cdhowe.org/pdf/Commentary_272.pdf.

subsidiaries). For related parties, the withholding tax will be reduced to 7% in the first calendar year after ratification of the Convention. This is reduced to 4% in the second year and is eliminated in subsequent years. The elimination of the withholding tax between unrelated parties should enable Canadian borrowers to access the US debt market more easily and reduce their borrowing costs when it is not possible to comply with the existing rules for preferential treatment of short- and medium-term debt.(18) This is especially true for short-tem debt.

2. Residency of Hybrid Entities

Historically, the Canada Revenue Agency (CRA) has denied treaty benefits to US LLCs that were not taxed in the United States. Further, the CRA did not provide treaty benefits to US *members* of LLCs. The fifth protocol amends the residency provisions of the fourth protocol so that tax treatment of LLC members will resemble that of LLCs. Thus, US resident members of US LLCs doing business in Canada will be granted treaty benefits in Canada.

The fifth protocol also introduces new rules to deny treaty benefits to certain hybrid entities commonly used in cross-border financing transactions. This change prevents an entity from using the benefit of treaty provisions and the national tax laws regarding residency to decrease the amount of withholding tax on interest paid. A second related rule applies to the income, profit or gain received by the creditor.

3. Prevention of Treaty Shopping

The limitation-on-benefits provision in Article XXIX A of the existing convention tries to prevent "treaty shopping." (19) The existing provision prevents a resident of a third state from using Canada as a conduit for the purpose of obtaining a US treaty benefit. The fifth protocol amends this article to deny treaty benefits to US residents unless they satisfy a new test based on actual business activity (new Article XXIX A). This will provide the CRA with a new alternative for preventing treaty abuses.

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(18) *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), s. 212(1)(*b*)(vii).

(19) Treaty shopping refers to the practice of routing income through particular jurisdictions in order to receive benefits that were designed by a tax treaty to be given only to residents of that particular jurisdiction. See also *Crown Forest*, s. 58.

4. Permanent Establishment and Service Providers

The fifth protocol introduces a new definition of "permanent establishment" for service providers (Article V). It is now easier to be deemed a permanent establishment in the US or Canada and thus be liable for income tax in either country (see paragraph 9 of Article V).

5. Mutual Agreement Procedure

The fifth protocol introduces a new binding arbitration procedure to resolve difficult disputes between the competent authorities of Canada and the US. The taxpayer has the option to use the arbitration result in judicial proceedings in either jurisdiction.

6. Personal Tax Measures

The stock options and consequent taxation of employees who change residence due to employment will be apportioned according to the amount of time spent in the US or Canada (see diplomatic notes in Annex B). The fifth protocol implements mutual recognition of contributions to a pension plan (new paragraph 8 of Article XVIII). This will allow income tax deductions by taxpayers in either country for pension contributions in the other country. A similar deduction is available for employers. This will facilitate movement of personnel between Canada and the US. The fifth protocol introduces a provision to prevent the double taxation of pre-emigration gains (new paragraph 7 of Article XIII). This new provision will allow a taxpayer to elect to be treated in the other country as having reacquired the property at the time of changing residence. This will prevent taxation of gains in the other country after being taxed in the country of origin due to tax rules that deem a person to have disposed of all capital property prior to leaving the country.