

PROTOCOL AMENDING TAX CONVENTION WITH CANADA

OCTOBER 30, 1997.—Ordered to be printed

Mr. Helms, from the Committee on Foreign Relations,
submitted the following

REPORT

[To accompany Treaty Doc. 105-29]

The Committee on Foreign Relations, to which was referred the Protocol Amending the Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital signed at Washington on September 26, 1980 as amended by the Protocols Signed on June 14, 1983, March 28, 1984 and March 17, 1995, signed at Ottawa on July 29, 1997, having considered the same, reports favorably thereon, with one declaration and one proviso, and recommends that the Senate give its advice and consent to ratification thereof, as set forth in this report and the accompanying resolution of ratification.

I. PURPOSE

The principal purposes of the existing treaty between the United States and Canada 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 income taxes of the two countries. The purpose of the proposed protocol is to modify the provisions of the existing treaty regarding source-country taxation of social security benefits and situs-country taxation of gains on stock of certain real property holding companies.

II. BACKGROUND

The proposed protocol was signed on July 29, 1997. The proposed protocol would amend the tax treaty between the United States and Canada signed on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, and March 17, 1995 (the "existing treaty").

The proposed protocol was transmitted to the Senate for advice and consent to its ratification on September 23, 1997 (see Treaty Doc. 105-29). The Senate Committee on Foreign Relations held a public hearing on the proposed protocol on October 7, 1997.

III. SUMMARY

The proposed treaty makes two modifications to the existing treaty. First, the proposed protocol modifies the provision in the existing treaty that allows a country to tax the gains of a resident of the other country from the sale of stock of a real property holding company to limit the reach of that provision only to stock of companies that are resident in the first country. Second, the proposed protocol replaces the provision in the existing treaty that allows social security benefits to be taxed only by the source country with a provision that allows such benefits to be taxed only by the recipient's country of residence.

IV. ENTRY INTO FORCE AND TERMINATION

A. ENTRY INTO FORCE

The proposed protocol is subject to ratification in accordance with the applicable procedures in each country, and instruments of ratification are to be exchanged as soon as possible. The proposed protocol will enter into force upon the exchange of instruments of ratification.

The provision of the proposed protocol regarding taxation of gains on stock of certain real property holding companies will be effective as of April 26, 1995. The provision of the proposed protocol regarding taxation of social security benefits generally will be effective for amounts paid or credited after 1995. However, the effect of the proposed protocol with respect to amounts paid or credited after 1995 and before the calendar year in which the protocol enters into force (or, if it enters into force after August 31 of the year, before the end of the calendar year in which it enters into force) is limited to specified refund procedures.

B. TERMINATION

The existing treaty, as amended by the proposed protocol, will remain in force until terminated by either country. The treaty provides that either country may terminate the treaty at any time after five years from the date of its entry into force by giving at least six months prior notice through diplomatic channels. If a country considers that a significant change in the tax laws of the other country should be accommodated by a modification of the treaty, the two countries are to consult with a view to resolving the matter; if the matter cannot satisfactorily be resolved, the first country may terminate the treaty without regard to the five-year limitation. With respect to taxes withheld at source on dividends, interest, royalties, pensions and annuities, and certain other income, a termination will be effective for amounts paid or credited on or after the first of January following the expiration of the six-month period. With respect to other taxes, a termination will be effective for taxable years beginning on or after the first of January following the expiration of the six-month period.

V. COMMITTEE ACTION

The Committee on Foreign Relations held a public hearing on the proposed protocol amending the tax treaty with Canada (Treaty

Doc. 105–29), as well as on other proposed tax treaties and protocols, on October 7, 1997. The hearing was chaired by Senator Hagel. The Committee considered these proposed treaties and protocols on October 8, 1997, and ordered the proposed protocol amending the tax treaty with Canada favorably reported by voice vote, with the recommendation that the Senate give its advice and consent to ratification of the proposed protocol, subject to a declaration and a proviso.

VI. COMMITTEE COMMENTS

The Committee believes that the proposed protocol amending the tax treaty with Canada is in the interest of the United States and urges that the Senate act promptly to give advice and consent to ratification. However, the Committee has taken note of certain issues raised by the proposed treaty and believes that the following comments may be useful to Treasury Department officials in providing guidance on these matters should they arise in the course of future treaty negotiations.

Under the existing treaty, the right of the situs country to tax residents of the other country on gains with respect to real property in the first country extends to gains with respect to stock of certain corporations if a sufficient portion of the assets of such a corporation consist of real property in the first country. Presently, the domestic laws of both countries with respect to the taxation of nonresidents' gains from domestic real property apply to gains from the stock of *domestic* corporations that hold sufficient domestic real property. Presently, the domestic laws of neither the United States nor Canada apply to gains from the stock of *foreign* corporations that hold real property. However, legislation was introduced in Canada that would tax nonresidents on gains from the stock of *foreign* corporations that hold sufficient Canadian real property. The effective date of this legislation, which has not been enacted to date, was April 26, 1995. Under such legislation, for example, a U.S. resident could be subject to Canadian tax on gains from the stock of a U.S. corporation that holds sufficient Canadian real property. The proposed protocol prevents the imposition on U.S. residents of tax on gains from the stock of non-Canadian corporations pursuant to the legislation. The Committee believes that this result is appropriate. In this regard, the Committee notes that many of the income tax treaties between Canada and other countries similarly prevent the imposition of such tax on residents of those countries.

Prior to its amendment by the 1995 protocol, the existing treaty provided for exclusive residence country taxation of social security benefits. Following the 1995 protocol, the existing treaty provided for exclusive source country taxation of social security benefits. Under the provision in the existing treaty, U.S. social security benefits paid to Canadian residents are subject to U.S. tax; the United States imposes a 30-percent withholding tax on 85 percent of the amount of social security benefits paid to nonresident alien individuals, for an effective tax rate of 25.5 percent. Similarly, under this provision, Canadian social security benefits paid to U.S. residents are subject to Canadian tax; Canada imposes a withholding tax of 25 percent on social security benefits of nonresident alien individ-

uals, unless the individual elects to file a Canadian tax return and pay tax at regular graduated rates.

The source country tax rules provided with the 1995 protocol have been criticized by residents of both Canada and the United States. The 25.5 percent U.S. withholding tax on U.S. social security benefits paid to Canadian residents under the existing treaty may be significantly higher than the Canadian tax that would be imposed on such amounts, particularly in the case of lower-income individuals. On the other hand, while the Canadian tax on Canadian social security benefits paid to U.S. residents under the existing treaty may be reduced from the 25 percent withholding tax, U.S. residents can obtain such reductions only by filing a Canadian income tax return. The Committee believes that the proposed protocol appropriately addresses these concerns by providing for exclusive residence country taxation of social security benefits.

VII. BUDGET IMPACT

The Committee has been informed by the staff of the Joint Committee on Taxation that the proposed protocol is estimated to cause a negligible change in fiscal year Federal budget receipts during the 1998–2007 period.

VIII. EXPLANATION OF PROPOSED PROTOCOL

A detailed, article-by-article explanation of the proposed protocol to the income tax treaty between the United States and Canada is set forth below.

Article 1

The proposed protocol amends Article XIII (Gains) of the existing treaty. Under the existing treaty, gains derived by a resident of one country from the alienation of real property situated in the other country may be taxed in the other country. For this purpose, real property situated in the United States includes a U.S. real property interest. “U.S. real property interests” include interests in U.S. corporations that hold or held U.S. real property, provided that at least 50 percent of the fair market value of such corporation is (or was) attributable to U.S. real property interests. Real property situated in Canada includes stock of a company, provided that the value of the company’s stock is derived principally from real property situated in Canada.

The proposed protocol provides that real property situated in the United States does not include stock of company that is not a resident of the United States. Similarly, the proposed protocol provides that real property situated in Canada includes stock of a company *that is resident in Canada* provided that the value of the company’s stock is derived principally from real property situated in Canada.

Article 2

The proposed protocol amends Article XVIII (Pensions and Annuities) of the existing treaty.

The existing treaty defines the term “pensions” to include any payment under a pension or other retirement arrangement. The proposed protocol clarifies that the term “pensions” generally does

not include any benefits under the social security legislation in either country paid with respect to government service.

The existing treaty provides that benefits under the social security legislation in one of the countries paid to a resident of the other country are taxable only in the source country. The proposed protocol provides that benefits under the social security legislation in one of the countries that are paid to a resident of the other country are taxable only in the recipient's country of residence. In this regard, U.S. social security benefits paid to a Canadian resident are taxable in Canada as though they were benefits under the Canada Pension Plan, except that 15 percent of such benefits is exempt from Canadian tax. Similarly, Canadian social security benefits paid to a U.S. resident are taxable in the U.S. as though they were a payment under the U.S. Social Security Act, except that a type of benefit that is not subject to Canadian tax when paid to Canadian residents is exempt from U.S. tax.

Article 3

The proposed protocol will enter into force upon the exchange of instruments of ratification. Article 1 of the proposed protocol, relating to the taxation of certain real property gains, will have effect as of April 26, 1995. Article 2 of the proposed protocol, relating to the taxation of social security benefits, generally will have effect with respect to amounts paid or credited after 1995. However, the effect of the proposed protocol with respect to amounts paid or credited after 1995 and before the calendar year in which the protocol enters into force (or, if it enters into force after August 31 of the year, before the end of the calendar year in which it enters into force) is limited.

The proposed protocol provides that, with respect to benefits paid or accrued during such period, the protocol will apply if the resident has applied to the competent authority of the source country for a refund of the tax on the benefits. In the case of benefits paid during such period by the United States to a Canadian resident, the Canadian competent authority will apply for and receive these refunds on behalf of the resident and remit to the resident the amount of such refund minus any additional tax imposed in Canada on the benefits. In this regard, the Canadian competent authority will apply for such refunds only if the additional Canadian tax imposed on the benefits is less than the tax imposed in the United States on the benefits.

The proposed protocol provides that all taxes refunded because of the protocol are refunded without interest and that any additional taxes imposed as a result of the protocol are computed as if those taxes become payable no earlier than December 31 of the year following the year the proposed protocol enters into force.

Finally, the proposed protocol provides that the competent authorities will establish procedures with respect to the refund application and will agree on additional procedures as are necessary to ensure the appropriate implementation of the protocol.

IX. TEXT OF THE RESOLUTION OF RATIFICATION

Resolved, (two-thirds of the Senators present concurring therein),
That the Senate advise and consent to the ratification of the Proto-

col Amending the Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital signed at Washington on September 26, 1980 as amended by the Protocols signed on June 14, 1983, March 28, 1984 and March 17, 1995, signed at Ottawa on July 29, 1997 (Treaty Doc. 105–29), subject to the declaration of subsection (a), and the proviso of subsection (b).

(a) DECLARATION.—The Senate’s advice and consent is subject to the following declaration, which shall be binding on the President:

(1) TREATY INTERPRETATION.—The Senate affirms the applicability to all treaties of the constitutionally based principles of treaty interpretation set forth in Condition (1) of the resolution of ratification of the INF Treaty, approved by the Senate on May 27, 1988, and Condition (8) of the resolution of ratification of the Document Agreed Among the States Parties to the Treaty on Conventional Armed Forces in Europe, approved by the Senate on May 14, 1997.

(b) PROVISIO.—The resolution of ratification is subject to the following proviso, which shall be binding on the President:

(1) SUPREMACY OF THE CONSTITUTION.—Nothing in the Treaty requires or authorizes legislation or other action by the United States of America that is prohibited by the Constitution of the United States as interpreted by the United States.