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The Fourth Protocol to the Income Tax Treaty Between the United States and Canada - A Step in the Right Direction

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COMMENT

THE FOURTH PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND CANADA—A STEP IN THE RIGHT DIRECTION

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I. INTRODUCTION

When a Canadian citizen receives Social Security benefits from the U.S. government, who has the right to tax those benefits—the United States or Canada? When a U.S. citizen sells shares of a U.S. company that owns Canadian real estate, does Canada have the right to tax the capital gains? These questions raise issues of cross-border tax legislation, which has currently become a major area of concern for both the U.S. and Canadian

governments. Two factors leading to the concern are the migration of citizens between the two countries and the proliferation of cross-border transactions between the United States and Canada in recent years.¹

In order to legislate cross-border taxation issues, in 1980 the two countries entered into the Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital (Income Tax Treaty).² On July 29, 1997, they signed the Fourth Protocol to the Income Tax Treaty between the United States and Canada (Fourth Protocol), thereby amending the Income Tax Treaty between the two countries.³ The Fourth Protocol deals with the taxation of cross-border Social Security benefits and capital gains on the sale of shares of companies with cross-border real estate holdings.⁴

This Comment discusses the Fourth Protocol with a view toward evaluating its impact on cross-border taxation of Social Security benefits and capital gains from the sale of shares of real estate holding companies. The signing of the Fourth Protocol came in response to a proposal by the Canadian government which would effectively result in double taxation of U.S. citizens.⁵ The major function of the Income Tax Treaty is to prevent double taxation of either U.S. or Canadian citizens on cross-border transactions;⁶ thus, the signing of the Fourth Protocol is a necessary response to protect taxpayers from being taxed on their income in both the United States and Canada.

Part II of this Comment examines the Income Tax Treaty, its background, and its intended purposes. Part III provides an analysis of the Fourth Protocol and discusses the Fourth Protocol's effect on taxpayers in the United States and Canada. Part

1. Bruce N. Lemons et al., *Changes in U.S.-Canadian Tax Treaty Resolve Conflicts and Present Planning Opportunities*, 82 J. TAX'N 42, 42 (1995).

2. Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, Sept. 26, 1980, U.S.-Can., T.I.A.S. No. 11087 [hereinafter Income Tax Treaty].

3. Fourth Protocol Amending the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, July 29, 1997, U.S.-Can., (CCH) ¶1949A [hereinafter Fourth Protocol].

4. *Tax Treaties: U.S., Canada Sign Fourth Treaty Protocol Dealing with Social Security, Real Property*, INT'L BUS. & FIN. DAILY (BNA), at D5 (July 30, 1997).

5. *Canada: Grams Says Canada Tax Proposal Could Harm U.S. Businesses*, INT'L BUS. & FIN. DAILY (BNA), at D5 (Mar. 28, 1997).

6. Catherine Brown, *The U.S.-Canada Tax Treaty: Its Impact on Cross Border Transfers of Technology*, 9 TRANSNAT'L LAW. 79, 80 (1996).

IV discusses the significance of the Fourth Protocol. Finally, this Comment concludes that the Fourth Protocol is an equitable solution to the dilemma of which country should be permitted to tax the recipient of a cross-border benefit, and thus the Protocol successfully resolves the problems which led to its creation.

II. THE INCOME TAX TREATY: BACKGROUND

The Income Tax Treaty between the United States and Canada was signed on September 26, 1980.⁷ Efforts by both countries to govern the taxation of cross-border benefits and transactions, while precluding double taxation of taxpayers, led to the enactment of the Income Tax Treaty.⁸ The primary purposes of the Income Tax Treaty are to avoid double taxation and to prevent tax evasion in either treaty country.⁹ The Income Tax

7. Income Tax Treaty, *supra* note 2.

8. Brown, *supra* note 6, at 80. According to Roy D. Hogg:

The new Canada-US income tax convention...was much more extensive than its predecessor. It was the product of long and difficult negotiations, and reflected the magnitude of economic interaction between the two nations, the level of sophistication of each country's economy, and, perhaps, the growing deficits and the need for tax revenue in both countries.

Roy D. Hogg, *Canada-US Tax Relations*, 43 CAN. TAX J. 1547, 1555 (1995). According to Joseph H. Guttentag, International Tax Counsel before the Senate Foreign Relations Committee, the general benefit of income tax treaties to taxpayers is the avoidance of double taxation:

An income tax treaty removes impediments to international trade and investment by reducing the threat of "double taxation" that can occur when both countries impose tax on the same income. I'd like to mention four different aspects of this general goal. First, an income tax treaty generally increases the extent to which exporters can engage in trading activity in the other country without triggering tax. Second, when that threshold is met and tax is imposed, it establishes rules that assign to one country or the other the primary right of taxation with respect to an item of income, it ensures appropriate deductions and reduces the withholding tax on flows of income. Third, the treaty provides a dispute resolution mechanism to prevent double taxation that sometimes can arise in spite of the treaty. Finally, and often most importantly, the treaty helps to create stability of tax rules and thereby encourages desirable economic activity.

Testimony of Treasury International Tax Counsel at Senate Foreign Relations Hearing on Tax Treaties, TAX NOTES TODAY, Oct. 9, 1997, available in LEXIS, Fedtax Library, TNT file [hereinafter Treas. Int'l Tax Counsel].

9. Joint Committee on Taxation, *JCT Explains Protocol to U.S.-Canada Income Tax Treaty*, 47 TAX ANALYSTS' DAILY TAX HIGHLIGHTS & DOCS. 555 (1997). According to the Joint Committee on Taxation:

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 seeks to mitigate

Treaty is indispensable to the governing of tax legislation between the United States and Canada¹⁰ because the "U.S. and Canadian tax systems often come into conflict because of the enormous volume of cross-border transactions and frequent migration of persons between the countries."¹¹

Tax practitioners in both countries are concerned about the tax implications that result from cross-border transactions.¹² The vast number of cross-border transactions raises the question of which tax law to apply when dealing with transactions between the two complex, sophisticated tax systems.¹³ The "United States generally taxes nonresident alien individuals and foreign corporations on all their income that is effectively connected with

this double taxation generally by allowing U.S. persons to credit foreign income taxes paid against the U.S. tax imposed on their foreign-source income.

Id. at 556. Joseph H. Guttentag claims, in his testimony to the Senate Foreign Relations Committee: "One of the principal ways in which double taxation is eliminated is by assigning the primary taxing jurisdiction in particular factual settings to one treaty partner or the other." Treas. Int'l Tax Counsel, *supra* note 8. Guttentag follows with a discussion of tax evasion:

The second major objective of our income tax treaty program is to prevent tax evasion and to ensure that treaty benefits flow only to the intended recipients. Tax treaties achieve this objective in at least two major ways. First, they provide for exchange of information between the tax authorities. Second, they contain provisions designed to ensure that treaty benefits are limited to real residents of the other treaty country and not to "treaty shoppers".

Id.

10. Treas. Int'l Tax Counsel, *supra* note 8.

11. Lemons et al., *supra* note 1, at 42. According to Robert D. Brown: "The tax treaty between Canada and the United States may well be the most important tax treaty in the world, in the sense that it covers a larger volume of trans-border investment and business activity than any other international tax convention." Robert D. Brown, *Negotiations for a New Tax Treaty Between Canada and the United States—A Long Story with a Happy Ending?*, 4 CAN.-U.S. L.J. 139, 140 (1978). In another article, Brown discusses the Canadian perspective on tax legislation between the two countries:

Given the huge volume of transborder investment and trade, the massive changes in the U.S. tax systems unexpectedly adopted by the United States in 1986 required Canada to accelerate and change its reform processes. First because of the large volume of reciprocal investment between the two countries, Canada was faced with the immediate necessity of reducing its tax rates, and most particularly its corporate tax rates, to levels that would roughly match those proposed in the United States. If Canada failed to do this, international corporations could readily shift, through a variety of means, substantial parts of the Canadian tax base to the United States in order to cut their overall tax liabilities.

Robert D. Brown, *Effects of U.S. and Canadian Tax Legislation: A Canadian Perspective*, 14 CAN.-U.S. L.J. 151, 159 (1988).

12. Nathan Boidman, *Canada-U.S. Tax Practice—A Cross-Border View*, 21 TAX MGMT. INT'L J. 88, 88 (1992).

13. *Id.*

the conduct of a trade or business in the United States.”¹⁴ The United States taxes nonresidents who conduct a trade or business in the United States at the same rate that it taxes U.S. residents conducting a trade or business.¹⁵

The Income Tax Treaty has been amended on three prior occasions since its enactment in 1980.¹⁶ The United States and Canada signed the First Protocol to the Income Tax Treaty (First Protocol) on June 14, 1983.¹⁷ The First Protocol dealt with income from real property, transportation, royalties, gains, artists and athletes, withholding of taxes, pensions and annuities, exempt organizations, the elimination of double taxation, and non-discrimination.¹⁸

The two countries signed the Second Protocol to the Income Tax Treaty (Second Protocol) on March 28, 1984.¹⁹ The Second Protocol amended Article XVIII (Pensions and Annuities) by providing that social security benefits would be taxed only by the resident country and that fifty percent of the benefit would be exempt from tax.²⁰ Eleven years later, conflicts arose with re-

14. Joint Committee on Taxation, *supra* note 9, at 556.

15. *Id.*

16. Fourth Protocol, *supra* note 3.

17. *Id.*

18. Protocol Amending the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, June 14, 1983, U.S.-Can., T.I.A.S. No. 11087 [hereinafter First Protocol]. Specifically in relation to the issues presented by the Fourth Protocol, the First Protocol provides: “Income derived by a resident of a Contracting State from real property (including income from agriculture, forestry or other natural resources) situated in the other Contracting State may be taxed in that other State.” *Id.* art. III.1. Additionally, with regard to gains, the First Protocol states:

For the purposes of this Article the term “real property situated in the other Contracting State”

(a) In the case of real property situated in the United States, means a United States real property interest and real property referred to in Article VI (Income from Real Property) situated in the United States; and

(b) In the case of real property situated in Canada means:

(i) Real property referred to in Article VI (Income from Real Property) situated in Canada;

(ii) A share of the capital stock of a company, the value of whose shares is derived principally from real property situated in Canada; and

(iii) An interest in a partnership, trust or estate, the value of which is derived principally from real property situated in Canada.

Id. art. VI.

19. Protocol Amending the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, Mar. 28, 1984, U.S.-Can., T.I.A.S. No. 11087, art. III [hereinafter Second Protocol].

20. *Id.* art. I. Specifically, Article I of the Second Protocol provides:

Benefits under the social security legislation in a Contracting State paid to a

gard to taxation of the estates of individuals with cross-border interests upon their death.²¹ In order to protect the taxpayers of both countries against double taxation at death, the countries signed the Third Protocol to the Income Tax Treaty (Third Protocol) on March 17, 1995.²² Additionally, the Third Protocol provided that only the country making cross-border social security payments, the source country, could tax the payments.²³ The Third Protocol also eliminated the fifty percent exemption from tax created by the Second Protocol.²⁴

The Canadian government's subsequent proposal in 1995 to amend its Income Tax Act concerned many Americans because of its potential to adversely affect the interests of U.S. businesses and taxpayers.²⁵ The Canadian proposal would have permitted Canada "to tax non-residents' gains on shares of non-resident corporations, and interests in non-resident trusts, where most of the value of the shares or interests is attributable to Canadian real estate."²⁶ Prior to the proposed amendment, Canada taxed

resident of the other Contracting State shall be taxable as follows:

- (a) Such benefits shall be taxable only in that other State;
- (b) Notwithstanding the provision of subparagraph (a), one-half of the total amount of any such benefit paid in a taxable year shall be exempt from taxation in that other state.

Id.

21. Arthur J. Dichter, *Protocol Coordinates Death Tax Provisions of U.S. and Canada*, 23 EST. PLAN. 296, 296 (1996). Dichter states:

The United States imposes estate tax on the worldwide assets of decedents who were either U.S. citizens or residents.... Canada does not impose an estate tax... As a result of the inconsistency between these two tax regimes, the estates of U.S. citizens residing in Canada, U.S. residents and citizens who own certain Canadian assets, and Canadian residents who own assets situated in the United States have been subject to double taxation at death.

Id.

22. Revised Protocol Amending the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, Mar. 17, 1995, U.S.-Can., (CCH) ¶1946, art. 3. [hereinafter Third Protocol].

23. Lemons et al., *supra* note 1, at 48. According to Article IX of the Third Protocol: "Benefits under the social security legislation in a Contracting State ... paid to a resident of the other Contracting State...shall be taxable only in the first-mentioned State." Third Protocol, *supra* note 22, art. 9.2.

24. Third Protocol, *supra* note 22, art. 9.2.

25. Canada: *Grams Says Canada Tax Proposal Could Harm U.S. Businesses*, *supra* note 5, at D5.

26. Canada: *Canada-United States Tax Treaty Change—Coopers & Lybrand*, BUS. MONITOR, Apr. 10, 1997, available in 1997 WL 10242462. According to the U.S. Department of Treasury:

[A]mendments were proposed to the Canadian Income Tax Act that would impose Canadian income tax on gains realized on stock of certain companies that are not residents of Canada if (i) more than 50 percent of the fair market

"non-residents' gains on some non-Canadian partnerships, but not on non-resident trusts or corporations."²⁷

Americans were concerned with the proposal because a great number of U.S. firms had considerable interest in Canadian real estate.²⁸ Both large and small U.S. businesses, which had invested a great amount of capital in Canadian real estate, would have been adversely affected by the amendment.²⁹ Concerned that the proposed amendment by the Canadian Parliament would negatively impact U.S. businesses and taxpayers, President Clinton, his staff, and members of Congress expressed concern about the proposal.³⁰

In order to prevent the injustice of double taxation of U.S. businesses and taxpayers, the United States actively negotiated an amendment to the Income Tax Treaty that would negate the impact of the Canadian tax proposal.³¹ The Canadian govern-

value of all of the company's properties consists of any combination of taxable Canadian property, Canadian resource property, timber resource property in Canada and income interests in Canadian trusts, and (ii) more than 50 percent of the fair market value of the shares in question is derived directly or indirectly from any combination of real property located in Canada, Canadian resource property, and timber resource property in Canada.

U.S. Dep't. of Treas., *Technical Explanation of Proposed Protocol to U.S.-Canada Income Tax Convention Signed July 29, 1997*, TAX NOTES TODAY, Oct. 10, 1997, § I.6, available in LEXIS, Fedtax Library, TNT file. The Department of Treasury calls this explanation "an official guide to the Protocol." *Id.* at intro.

27. *Canada: Canada-United States Tax Treaty Change-Coopers & Lybrand*, *supra* note 26.

28. *Canada: Grams Says Canada Tax Proposal Could Harm U.S. Businesses*, *supra* note 5.

29. *Id.*

30. Rob Wells, *Canadian Tax Plan Worries U.S. Leaders*, THE RECORD (Northern N.J.), Mar. 27, 1997, at A24. According to the article:

A proposed change in the definition of taxable Canadian property would essentially expose some U.S. companies to double taxation during certain transactions, such as sale of a major ownership stake in the business, experts say. It's unknown exactly how many companies would be snared by the change, which the Canadians hope will prevent foreign corporations with more than half of their assets in Canadian real estate from escaping local taxation.

Id. According to United States Senator Rod Grams: "If adopted this Canadian tax would result in double taxation of U.S. citizens." *Id.* Michael J. Cooper of "Big 6" accounting firm, Deloitte & Touche argued that the proposal would have "produced unjust results and would have inappropriately eroded the U.S. tax base." Michael J. Cooper, *Deloitte & Touche Thanks Treasury for Preventing Implementation of Canadian Tax Proposal*, TREASURY TAX CORRESPONDENCE, May 1, 1997, available in WESTLAW, TAXANALYST database.

31. Cooper, *supra* note 30; see also Protocol Amending Tax Convention with Canada, July 29, 1997, U.S.-Can., S. Exec. Rep. No. 105-12 (Oct. 30, 1997), available in

ment also perceived inequities in the taxation of some of its citizens under the Income Tax Treaty, in the form of an American flat tax on outbound Social Security benefits.³² Under the flat tax, a measure undertaken by the U.S. government in 1996, the United States withheld 25.5% of Social Security payments to Canadian residents.³³ The flat tax adversely affected low-income Canadians who received Social Security payments from the United States³⁴ because the United States did not permit Canadian residents to file tax returns in the United States.³⁵

Alternatively, Canada permitted non-resident pensioners to file Canadian tax returns, thereby effectively allowing many low-income American citizens who received Canadian Social Security benefits, to "pay little or no Canadian tax on their Canadian benefits."³⁶ As a form of compromise, the United States agreed to "no longer withhold 25.5 per cent of outbound social-security payments," and Canada "agreed to drop a proposal to tax capital gains earned by U.S. residents on the shares of corporations whose value is made up mostly of Canadian real estate."³⁷ The compromise took the form of the Fourth Protocol to the Income Tax Treaty between the United States and Canada.³⁸

LEXIS, Fedtax Library, TNT file.

32. April Lindgren, *U.S. Pensioners Living in Canada to Get a Break on Their Taxes*, OTTAWA CITIZEN, Apr. 10, 1997, at C1.

33. *Id.* According to the U.S. Senate Committee on Foreign Relations:

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.

Protocol Amending Tax Convention with Canada, *supra* note 31, § VI.

34. Lindgren, *supra* note 32, at C1.

35. *Canada: Canada-United States Tax Treaty Changes—Coopers & Lybrand*, *supra* note 26.

36. *Id.* Low-income American citizens pay little or no Canadian tax on their Canadian benefits, since the only income reported on their Canadian tax return is likely the Social Security payments. *Id.* As the sole form of income, the payments would place the American citizens in the lowest Canadian tax bracket, which would allow them to pay little or no Canadian tax. *Id.*

37. April Lindgren, *Low-income Recipients of Social Security Get Tax Break*, MONTREAL GAZETTE, Apr. 10, 1997, at A11.

38. *Canada: Canada-United States Tax Treaty Changes—Coopers & Lybrand*, *supra* note 26.

III. ANALYSIS OF THE FOURTH PROTOCOL

The Fourth Protocol was signed on July 29, 1997, and entered into force on December 16, 1997.³⁹ The Fourth Protocol applies retroactively.⁴⁰ Article 1, governing taxation of capital gains on real property, applies as of April 26, 1995.⁴¹ Article 2 of the Protocol, the provision dealing with taxation of Social Security benefits, applies as of January 1, 1996.⁴²

A. *Tax on Capital Gains*

The Fourth Protocol amends Article XIII (Gains) of the Income Tax Treaty.⁴³ Prior to ratification of the Fourth Protocol, Article XIII of the Income Tax Treaty provided that:⁴⁴

3. Gains derived by a resident of a Contracting State from the alienation of:

(a) Shares forming part of a substantial interest in the capital stock of a company which is not a resident of that State the value of which shares is derived principally from real property situated in the other Contracting State; or

39. John Iekel, *Five U.S. Tax Treaties, One Protocol Enter Into Force*, TAX NOTES TODAY, Dec. 31, 1997, available in LEXIS, Fedtax Library, TNT file.

40. *Signing of Fourth Protocol to Canada-U.S. Tax Treaty*, TAX NOTES INT'L, Aug. 6, 1997, at 5, available in WESTLAW, TAXANALYST database.

41. Protocol Amending Tax Convention with Canada, *supra* note 31, § IV.A.

42. *Signing of Fourth Protocol to Canada-U.S. Tax Treaty*, *supra* note 40. According to the Department of Finance:

This new rule will apply as of January 1, 1996, the date the current rule came into effect. Excess tax collected under the current rule will therefore be refunded to Social Security recipients in both countries. The change brings retroactive relief, but does not increase anybody's tax for the retroactive period.

Id. In order to prevent an increase in anyone's tax during the retroactive period, "Canada will ensure that the tax that applies to Canadian residents for 1996 and 1997 does not exceed the tax that the U.S. collected." *Id.*

43. Fourth Protocol, *supra* note 3, arts. 1 & 2.

44. Income Tax Treaty, *supra* note 2, art. XIII.

(b) An interest in a partnership, trust or estate the value of which is derived principally from real property situated in the other Contracting State may be taxed in that other State, provided that the laws in force in the first-mentioned State at the time of such alienation would, in comparable circumstances, subject to taxation gains derived by a resident of that other State.

Tax practitioners interpreted Article XIII as providing that "Canada can tax capital gains realized by a resident of the U.S. on the shares of (or an interest in) any corporation, trust or partnership whose value is mostly made up of Canadian real estate."⁴⁵ As a result of Canada's ability to tax U.S. citizens on capital gains, the United States is able to tax Canadian citizens on capital gains from U.S. real property interests.⁴⁶ U.S. real property interests are defined as including some "Canadian partnerships and trusts that hold U.S. property, but [do] not include shares of any non-U.S. corporations."⁴⁷ In sum, prior to the Fourth Protocol's enactment, the United States and Canada could tax businesses and individuals from the other country on capital gains realized from the sale of real property located in their country.⁴⁸

The alternative to the current system is to create a system in which each country gives to its residents the exclusive right to tax capital gains from real estate.⁴⁹ Article 1 of the Fourth Protocol amends the language of the Income Tax Treaty with respect to taxation of capital gains:

45. *Canada: Canada-United States Tax Treaty Change—Coopers & Lybrand*, *supra* note 26. The Department of Treasury, citing Paragraph 3(b) of Article III of the Treaty, states that Canada can tax a "share of stock of a company, the value of whose shares consists principally of Canadian real property; and an interest in a partnership, trust or estate, the value of which consists principally of Canadian real property. The term principally means more than 50 percent." U.S. Dep't. of Treas., *supra* note 26.

46. *Canada: Canada-United States Tax Treaty Change—Coopers & Lybrand*, *supra* note 26.

47. *Id.*

48. *Id.*

49. Brown, *Negotiations for a New Tax Treaty*, *supra* note 11, at 141. According to Robert D. Brown:

The United States clearly [favors] the system of taxation which gives the country in which the taxpayer lives the primary right to tax him; whereas Canada, as a capital importing country, wants to assert that it is the country where the source of the income is, rather than where the taxpayer resides, that should have the first kick at the taxation cat.

Id. at 141, 142.

Paragraph 3(a) of Article XIII (Gains) of the Convention shall be deleted and replaced by the following:

In the case of real property situated in the United States, means a United States real property interest and real property referred to in Article VI (Income from Real Property) situated in the United States, but does not include a share of the capital stock of a company that is not resident of the United States; and

Paragraph 3(b)(ii) of Article XIII (Gains) of the Convention shall be deleted and replaced by the following:

A share of the capital stock of a company that is a resident of Canada, the value of whose shares is derived principally from real property situated in Canada;⁵⁰

The effect of the Fourth Protocol is that "Canada will agree not to tax U.S. residents' gains on shares of corporations that are not resident in Canada."⁵¹ Further, the United States will agree that shares of Canadian corporations will not constitute U.S. real property interests.⁵²

Canada's agreement not to tax capital gains realized by U.S. citizens on the sale of shares of corporations resident in the United States represents a change in Canadian tax law.⁵³ Prior to the Fourth Protocol, Canada had the "right to tax nonresidents' gains on shares of nonresident corporations when most of the value of the shares [was] attributable to Canadian real estate."⁵⁴ The Fourth Protocol transfers the right to tax the capital gains from the Canadian government to the U.S. government.⁵⁵

Under the Fourth Protocol, "Canadians who invest in U.S. real estate through Canadian companies will continue to pay

50. Fourth Protocol, *supra* note 3, art. 1.2.

51. *Canada: Canada-United States Tax Treaty Changes—Coopers & Lybrand, supra* note 26.

52. *Id.*

53. Steven Grodnitzky, *Canada and U.S. Sign Fourth Protocol*, 46 TAX ANALYSTS' DAILY TAX HIGHLIGHTS & DOCS. 1264 (1997).

54. *Id.* at 1265.

55. *Id.*

Canadian tax, rather than any possible future U.S. tax when they sell their shares."⁵⁶ Conversely, U.S. citizens who invest in U.S. companies with an interest in Canadian real estate are only taxed in the United States on their capital gains.⁵⁷ In essence, the Fourth Protocol gives each country the exclusive right to tax its residents on capital gains from the sale of shares of non-resident corporations.⁵⁸

The benefit of the Fourth Protocol to the U.S. taxpayers is that it exempts U.S. residents from the Canadian capital gains tax on sales of stock in U.S. companies with substantial Canadian property.⁵⁹ The Fourth Protocol's enactment will allay the fears of American businesses, taxpayers, and politicians.⁶⁰ No longer do American taxpayers have to be concerned that the Canadian government might "inappropriately erode the U.S. tax base,"⁶¹ and effectuate a double taxation of U.S. citizens.⁶²

B. Tax on Social Security

In order to prevent the injustice of the Canadian tax proposal, and as a form of compromise, the United States agreed to eradicate Canadian concerns with U.S. taxation of Social Security benefits.⁶³ The Fourth Protocol amends the Income Tax

56. Cooper, *supra* note 30; see Fourth Protocol, *supra* note 3, art. 1.

57. Fourth Protocol, *supra* note 3, art. 1.

58. *Signing of Fourth Protocol to Canada-U.S. Tax Treaty*, *supra* note 40. According to the Joint Committee on Taxation:

Treaties define the term 'resident' so that an individual or corporation generally will not be subject to tax as a resident by both 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.

Joint Committee on Taxation, *supra* note 9, at 557.

59. *Canada: Canada-United States Tax Treaty Changes—Coopers & Lybrand*, *supra* note 26.

60. Cooper, *supra* note 30. According to Rob Wells, the "Clinton administration and a growing number in Congress are raising alarm over a bill before the Canadian Parliament that could create a major tax headache for U.S. businesses with significant property ownership in that country." Wells, *supra* note 30.

61. Cooper, *supra* note 30.

62. *Canada: Grams Says Canada Tax Proposal Could Harm U.S. Businesses*, *supra* note 5.

63. *Death and Taxes: Seniors Might Die Before They Benefit from New Tax Deal with U.S.*, MONTREAL GAZETTE, Apr. 14, 1997, at E14.

Treaty Article XVIII, which concerns cross-border pensions and annuities.⁶⁴

Article XVIII of the Income Tax establishes which country can tax Social Security benefits.⁶⁵ Prior to 1996, under the Income Tax Treaty, only the country where the recipient of the Social Security benefit lived (the resident country) could tax the benefit.⁶⁶ The resident country's taxation of the benefit was limited in that the "country where the recipient lived could include half the benefit in the recipient's taxable income. The other half was entirely tax-free."⁶⁷ Changes to the Income Tax Treaty in 1996 permitted the country that paid the benefit—the source of the income—to tax the benefit completely.⁶⁸ Prior to the signing of the Fourth Protocol, Article XVIII of the Income Tax Treaty provided in pertinent part that "[b]enefits under the Social Security legislation in a Contracting State paid to a resident of the other Contracting State or a citizen of the United States shall be taxable only in the first-mentioned State."⁶⁹

Prior to the enactment of the Fourth Protocol, Canada taxed "outbound Canada (and Quebec) Pension Plan and Old Age Security benefits at a twenty-five per cent rate."⁷⁰ Canada allowed U.S. citizens receiving Canadian Social Security benefits to file a Canadian tax return, rather than taxing the U.S. citizens at the flat rate of twenty-five percent.⁷¹ Consequently, "many low-income U.S. recipients...pay little or no Canadian tax on their Canadian benefits."⁷² In contrast, the United States taxed Canadian recipients of U.S. Social Security benefits at a rate of

64. Fourth Protocol, *supra* note 3, art. 2; *see also* Income Tax Treaty, *supra* note 2, art. XVIII.

65. *Signing of Fourth Protocol to Canada-U.S. Tax Treaty*, *supra* note 40. According to the background information: "Both Canada and the United States pay social security benefits to large numbers of people in the other country. Most of these are people who worked in one country and retired to the other. Others are persons with disabilities, or the surviving spouses or children of cross-border workers." *Id.*

66. *Id.*

67. *Id.*

68. *Id.*

69. Income Tax Treaty, *supra* note 2, art. XVIII.

70. *Signing of Fourth Protocol to Canada-U.S. Tax Treaty*, *supra* note 40.

71. *Id.*

72. *Id.*

twenty-five and a half percent.⁷³ Instead of giving Canadian citizens the right to file a U.S. tax return, the United States taxed them at a flat rate, which is "fixed and final."⁷⁴

The Fourth Protocol changes the system of taxation of cross-border Social Security payments between the United States and Canada.⁷⁵ Article 2 of the Fourth Protocol provides:

Paragraph 5 of Article XVIII (Pensions and Annuities) of the Convention shall be deleted and replaced by the following:

5. Benefits under the Social Security legislation in a Contracting State... paid to a resident of the other Contracting State shall be taxable only in that other State....⁷⁶

According to the Fourth Protocol, the "country of residence will have the exclusive right to tax Social Security benefits."⁷⁷ Thus, only the United States will be able to tax Social Security benefits the Canadian government pays to U.S. citizens;⁷⁸ whereas, only Canada will be able to tax Social Security benefits paid to Canadian citizens.⁷⁹ The taxation of Social Security benefits by the country of residence is subject to special conditions enumerated in paragraphs 5(a) and 5(b) of Article 2 of the

73. *Id.*

74. *Id.*

75. Fourth Protocol, *supra* note 3, art. 2.2.

76. *Id.* Paragraph 5 is subject to the following conditions:

(a) a benefit under the social security legislation in the United States paid to a resident of Canada shall be taxable in Canada as though it were a benefit under the Canada Pension Plan, except that 15 per cent of the amount of the benefit shall be exempt from Canadian tax; and

(b) a benefit under the social security legislation in Canada paid to a resident of the United States shall be taxable in the United States as though it were a benefit under the Social Security Act, except that a type of benefit that is not subject to Canadian tax when paid to residents of Canada shall be exempt from United States tax.

Id. In addition to amending Paragraph 5 of Article XVIII of the Income Tax Treaty, the Fourth Protocol also amends Paragraph 3 of Article XVIII. The change in Paragraph 3 of Article XVIII of the Treaty is that "[t]he 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." Joint Committee on Taxation, *supra* note 9, at 557.

77. *Signing of Fourth Protocol to Canada-U.S. Tax Treaty*, *supra* note 40.

78. *Id.*

79. *Id.*

Fourth Protocol:⁸⁰ "For residents of Canada, only 85 per cent of U.S. benefits will be included in taxable income.... For U.S. residents, any type of Canadian benefit that is exempt from tax in Canada will also be exempt in the United States."⁸¹ By signing the Fourth Protocol, the United States and Canada have returned to the pre-Third Protocol system, in which only the resident country can tax cross-border Social Security benefits.⁸²

As a result of the Fourth Protocol, the United States no longer taxes Canadian residents on Social Security payments received from the United States.⁸³ Instead, Canadian residents report eighty-five percent of cross-border Social Security payments on their Canadian income tax returns,⁸⁴ and the remaining fifteen percent is exempt from Canadian tax.⁸⁵

The primary beneficiaries of the Fourth Protocol, with regard to changes made to the taxation of cross-border Social Security benefits⁸⁶ are "lower-income Canadians who receive U.S. Social Security benefits, thousands of Canadians with disabilities, and retired Canadians."⁸⁷ Instead of being taxed by the U.S. government on their cross-border Social Security benefits, under the Fourth Protocol, only the Canadian government taxes Canadian residents.⁸⁸ This change is clearly beneficial to lower-income Canadians, who will no longer be subject to the U.S. flat tax on Social Security benefits, but rather can simply file a Canadian tax return.⁸⁹ The U.S. Social Security benefits which are implicated by the Fourth Protocol are "those provided under Title II of the U.S. Social Security Act. These include retirement, survivor, and disability benefits."⁹⁰ Currently, around 85,000

80. Fourth Protocol, *supra* note 3, art. 2.

81. *Id.* According to Article 2, Paragraph 5(b), of the Fourth Protocol: "a type of benefit that is not subject to Canadian tax when paid to residents of Canada shall be exempt from United States tax." See Fourth Protocol, *supra* note 3, art. 2.

82. Arthur Drache, *Treaty Change Ends Benefit Withholdings*, FIN. POST, May 6, 1997, at 28.

83. *Death and Taxes: Seniors Might Die Before They Benefit from New Tax Deal with U.S.*, *supra* note 63.

84. *Id.*

85. Fourth Protocol, *supra* note 3, art. 2.

86. *Id.*

87. *Tax Treaties: U.S., Canada Initial Protocol to Income Tax Treaty*, Treasury Says, DAILY TAX REP., Apr. 10, 1997, at D14.

88. *Signing of Fourth Protocol to Canada-U.S. Tax Treaty*, *supra* note 40.

89. Lindgren, *supra* note 32, at C1.

90. *Signing of Fourth Protocol to Canada-U.S. Tax Treaty*, *supra* note 40. In addition to the benefits mentioned, "Railroad retirement benefits provided under Tier 1 of the

Canadian residents receive Social Security benefits from the United States.⁹¹ As a result of the Fourth Protocol, "[t]housands of retired Canadians and Canadians with disabilities will no longer have to pay any tax at all and thousands more will pay less tax than they otherwise would."⁹²

The Fourth Protocol adversely affects high income Canadians who receive U.S. Social Security benefits.⁹³ The flat tax of 25.5% they had been paying on U.S. Social Security benefits is lower than the tax rate they incur in Canada on their Canadian income, the rate that now applies to Canadians under the Fourth Protocol.⁹⁴ Additionally, Canada has a "separate rule that requires [Canadians resident in the U.S.] to pay tax to Canada on their worldwide income."⁹⁵

IV. SIGNIFICANCE OF THE FOURTH PROTOCOL

The Fourth Protocol just recently entered into force;⁹⁶ its significance and effect on the taxation of United States and Canadian taxpayers has yet to be determined. The signing of the Fourth Protocol is important for the protection of the interests of U.S. taxpayers.⁹⁷ It originated as a response to the Canadian government's proposal to create a tax regime that would result in the double taxation of U.S. citizens.⁹⁸ U.S. businesses and taxpayers were concerned with the "proposed change in the

Railroad Retirement Act are also affected." *Id.* As an example of the benefits of the Fourth Protocol, "[u]nder the Canadian tax regime, a senior [citizen] living on a \$12,000 pension from the United States would pay little or no tax to Revenue Canada." *Id.* In contrast, under the current system, that same Canadian senior citizen would be taxed at a flat rate of 25.5 per cent because the "U.S. government withholds 25.5 per cent of the money regardless of income." *Id.*

91. *Death and Taxes: Seniors Might Die Before They Benefit from New Tax Deal with U.S.*, *supra* note 63.

92. James Daw, *Tax Treaty Could Lead to Refunds; Tax Burden Cut on U.S. Benefits*, *TORONTO STAR*, Apr. 12, 1997, at E8. According to the article, "U.S. Treasury Secretary Robert Rubin has agreed with Canada's Finance Minister Paul Martin to change a tax treaty that left many people living on low incomes paying more than they should have." *Id.*

93. Drache, *supra* note 82.

94. Daw, *supra* note 92.

95. Drache, *supra* note 82.

96. Iekel, *supra* note 39.

97. *Canada: Grams Says Canada Tax Proposal Could Harm U.S. Businesses*, *supra* note 5.

98. *Id.*

definition of taxable Canadian property,"⁹⁹ because the proposal would lead to double taxation of U.S. businesses and taxpayers.¹⁰⁰ According to the Fourth Protocol, in the area of capital gains, "Canada will agree not to tax U.S. residents' gains on shares of corporations not resident in Canada."¹⁰¹ Even though Canada will not tax U.S. taxpayers on capital gains, "U.S. investors in U.S. companies that hold property in Canada will still pay U.S. tax when they sell their shares."¹⁰² The Fourth Protocol's impact on U.S. businesses and taxpayers is open to debate because it is impossible to determine how many companies would have been affected by the Canadian tax proposal.¹⁰³ Allegedly, the proposed changes in Canadian tax law would adversely affect family business, small business, privately held companies, and multinational companies with large Canadian real estate interests.¹⁰⁴

Arguably, the Canadian government is justified in taxing capital gains realized by U.S. citizens. The Canadian tax proposal can simply be viewed as the Canadian government's attempt to "prevent foreign corporations with more than half of their assets in Canadian real estate from escaping local taxation."¹⁰⁵ According to the Canadian government, the proposal is permitted by the Income Tax Treaty because "U.S. corporations could apply for a foreign tax credit to deduct the cost of the new Canadian tax."¹⁰⁶ Looking forward, the important point is that the Fourth Protocol solves the problem of which country—the source country or the resident country—should be able to tax capital gains.¹⁰⁷

On the Canadian side of the border, the Fourth Protocol will relieve the hardship the U.S. flat tax imposed on thousands of Canadian residents.¹⁰⁸ Since the U.S. flat tax was announced in 1996, many Canadians have been disturbed by the Canadian government's inability to protect the interests of its citizens.¹⁰⁹

99. Wells, *supra* note 30.

100. *Id.*

101. *Signing of Fourth Protocol to Canada-U.S. Tax Treaty*, *supra* note 40.

102. *Id.*

103. Wells, *supra* note 30.

104. *Id.*

105. *Id.*

106. *Id.*

107. *Signing of Fourth Protocol to Canada-U.S. Tax Treaty*, *supra* note 40.

108. Lindgren, *supra* note 32, at C1.

109. Suzanne Snider, *Talking Point: 'Working on It' Not a Sufficient Reply*, WINDSOR

The Fourth Protocol is a positive step for the estimated 85,000 Canadians receiving cross-border Social Security benefits.¹¹⁰ Rather than being taxed on the Social Security benefits they receive from the United States at the flat rate of 25.5%, thousands of Canadian residents receiving Social Security benefits from the United States will pay less tax or no tax at all to the Canadian government.¹¹¹

Unfortunately, the intended beneficiaries may not realize all of the benefits of the Fourth Protocol. Some elderly Canadian citizens will die before they receive a refund from the U.S. government.¹¹² Even though the changes to the taxation of Social Security benefits will apply retroactively,¹¹³ tax refunds for 1996 and 1997 withholdings by the U.S. government might not be issued until 1998.¹¹⁴ The Canadian Association of Retired Persons (CARP) is opposed to the Fourth Protocol because it subjects Canadian recipients of U.S. Social Security benefits to double taxation.¹¹⁵ CARP argues that a Canadian citizen who worked in the United States incurred Social Security taxes at the time income

STAR, Feb. 25, 1997, at A7. According to Snider, in an article written prior to the signing of the Fourth Protocol:

The lack of movement on the part of my government really disturbs me. They have negotiated treaty changes that favor Canadians living in the United States and U.S. citizens living in Canada (all collecting United States Social benefits and Old Age Security benefits from Canada) over Canadians living at home and still supporting all our tax bases. We have people living at the poverty line and below that have had their income cut by 25.5 per cent. Why? Thirteen months have passed and 'we are working on it' is just not good enough. We cannot afford to wait another day.

Id. In an article written about finance minister Paul Martin's being groomed for prime minister, G. Larking wrote:

Ask the thousands and thousands of Canadians receiving U.S. Social Security benefits. Mr. Martin, in his infinite wisdom, saw fit to enter into a tax treaty with the United States that said take 25.5 per cent of their benefits and keep it in your treasury. Only in Canada with a finance minister like Mr. Martin could this happen.

G. Larking, *Talking Point: Paul Martin Unsited to be Prime Minister*, WINDSOR STAR, Apr. 4, 1997, at A9.

110. *Death and Taxes: Seniors Might Die Before They Benefit from New Tax Deal with U.S.*, *supra* note 63.

111. *Daw*, *supra* note 92.

112. *Death and Taxes: Seniors Might Die Before They Benefit from New Tax Deal with U.S.*, *supra* note 63.

113. *Signing of Fourth Protocol to Canada-U.S. Tax Treaty*, *supra* note 40.

114. *Death and Taxes: Seniors Might Die Before They Benefit from New Tax Deal with U.S.*, *supra* note 63.

115. Lilian Morgenthau, *Canadian Retirees Seek Reduction in Tax on Social Security Income*, TAX NOTES TODAY, July 31, 1997, available in LEXIS, Fedtax library, TNT file.

was earned; under the Fourth Protocol, when the Canadian citizen receives Social Security benefits from the United States, the Canadian government will tax that income for a second time.¹¹⁶ In addition, according to Canadians Asking for Social Security Equality (CASSE), the Fourth Protocol does not benefit higher income Canadians.¹¹⁷ Instead of paying taxes on fifty percent of the social security benefits paid to them by the U.S. government, under the Fourth Protocol, higher income Canadians will pay taxes on eighty-five percent of the benefits.¹¹⁸ CASSE argues that this change "will unfairly target the middle class."¹¹⁹ A recent article in the Windsor Star proclaims, "Canadian seniors on U.S. social security took another hit to their incomes Monday, when an amendment to the Canada-U.S. tax treaty passed quietly through the House of Commons with resounding support from the liberal government."¹²⁰ Despite its inability to benefit all Canadian residents, the Fourth Protocol is nevertheless significant because it alleviates the inequity of the U.S. flat tax on low income Canadians.¹²¹

In signing the Fourth Protocol, the United States and Canada indicate their stance on which country should be able to tax cross-border benefits and transactions.¹²² In the areas of capital gains on real estate and Social Security benefits, it is clear that

116. *Id.* Lilian Morgenthau, President of CARP, stated in a letter to the U.S. Secretary of the Treasury on the Fourth Protocol:

The latest revision at which Social Security taxable income is leveled at 85% of income represents a 15% reduction from the 100% taxable level set in the previous revision and eliminates the 25.5% withholding tax collected by your government with the money collected thusfar being fully refunded. However, at the same time it represents a 35% increase over the 50% taxable rate level that existed in 1995. According to analysis this increase translates into a 70% increase in income tax—from people who live on fixed income.

Id.

117. *Politics: Shaughnessy Cohen Wins Acclamation*, WINDSOR STAR, Apr. 22, 1997, at A4. CASSE further argued that they thought:

[C]hanges recommended to a Canada-U.S. tax treaty would save money for Canadian seniors who collect U.S. social security pensions. But [Bill Thrasher, a spokesman for CASSE,] said he thinks the deal means more people will be paying more tax than they did in 1995. They must pay tax on 85 per cent of their U.S. income instead of the 50 per cent they paid in 1995, he said.

Politics: Whelan Acclaimed, WINDSOR STAR, Apr. 21, 1997, at A5.

118. *Politics: Shaughnessy Cohen Wins Acclamation*, *supra* note 117.

119. *Id.*

120. *Tax Treaty Changes Anger Seniors*, WINDSOR STAR, Dec. 6, 1997, at A5.

121. Drache, *supra* note 82.

122. Protocol Amending Tax Convention with Canada, *supra* note 31.

the country of residence should have the sole right to tax its citizens.¹²³ Recent developments in the area of cross-border taxation between the United States and Canada implicate the Income Tax Treaty and the issue of whether the source country should have the right to tax non-resident income.¹²⁴

More specifically, the tax issues raised by transferring employees between the United States and Canada have become issues of recent public debate.¹²⁵ Cross-border business transactions are becoming more common, and employers frequently send employees abroad to work on certain projects.¹²⁶ It is important for businesses to understand the tax implications of those actions.¹²⁷ For example, "a Canadian company may be shocked to learn that sending workers to the United States for short-term assignments may cause it to become subject to U.S. withholding tax."¹²⁸

The primary purpose of the Income Tax Treaty is to avoid double taxation; thus, it is important for the protection of the taxpayer to determine which country has the right to tax the income.¹²⁹ The Fourth Protocol indicates an intention by both the United States and Canada to permit only the country of residence, but not the source country, to tax income from cross-border transactions. If those intentions can be transferred to the cross-border employment context, then it logically follows that the right to tax should lie with the country of residence. It is possible that in the near future, this issue will become important enough to necessitate further legislative action.

V. CONCLUSION

The overriding purpose of the Fourth Protocol is to uphold the theme upon which the Income Tax Treaty itself was based, namely, the avoidance of double taxation in the determination of

123. *Id.*

124. See, e.g., Mary Ann Mayo, *Transferring Employees Abroad Raises Tax Issues; Companies Planning to Assign Employees to a Foreign Country, Even Temporarily, Need to Examine the Tax Consequences*, NAT'L L.J., Aug. 25, 1997, at B7.

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.*

tax liability.¹³⁰ The vast amount of cross-border transactions occurring between the United States and Canada¹³¹ demands a system to govern taxation of cross-border transactions. The Fourth Protocol creates a shift in the right to tax cross-border benefits from the country paying the benefit to the country in which the taxpayer is a resident.¹³² The shift in taxation that the Fourth Protocol created is an equitable solution to the dilemma of which country should be permitted to tax the recipient of a cross-border benefit. The Fourth Protocol to the Income Tax Treaty will be lauded as a great piece of tax legislation written to uphold the interests of taxpayers in avoiding excessive taxation on cross-border benefits and transactions. The future of tax legislation between the United States and Canada remains unclear, but with the signing of the Fourth Protocol, the legislators of both countries have taken a step in the right direction.

ADAM D. LUSTIG*

130. Protocol Amending Tax Convention with Canada, *supra* note 31.

131. Boidman, *supra* note 12, at 88.

132. *Signing of Fourth Protocol to Canada-U.S. Tax Treaty*, *supra* note 40.

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