

The Canada-U.S. Tax Treaty: Problems With the One-Sided LOB Article

by Ronny Buni

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The third protocol of the Canada-U.S. tax treaty added a provision to the pensions and annuities article to relieve taxation of interest accruing in tax-deferred arrangements of either state until disbursement or rollover.¹ The new rule replaced a prior miscellaneous rule that provided relief only to U.S. citizens resident in Canada, and then only against U.S. taxation of interest accruing in their registered retirement savings plans (RRSPs).² The new rule reads substantially as follows:

A natural person who is a citizen or resident of a Contracting State and a beneficiary of a [tax-deferred savings plan in the other State] may elect to defer taxation in the first-mentioned State, under rules established by the competent authority of that State, with respect to any income accrued in the plan but not distributed. . . .

Unfortunately, the limitation on benefits (LOB) article, also introduced by the third protocol, undoes the relief for U.S. residents with RRSPs and other forms of Canadian tax-deferred savings. The LOB article first provides that for the purpose of application by the United States, only qualifying persons, with some exceptions,³ are entitled to treaty benefits.⁴ The article then defines qualifying persons. As it turns out, only residents of Canada are qualifying persons.⁵ Thus, probably the largest class of persons

¹Canada-U.S. tax treaty, art. XVIII(7) (added by art. 9, para. 3 of third protocol). Under a Haig-Simons formulation, income is the sum of consumption and change in total wealth. Interest accruing to savings is normally taxable currently under an income tax because it represents an increase in wealth. While U.S. law provides special exceptions for certain savings plans, no provision of U.S. domestic law exempts the interest accruing to RRSPs. Nor does U.S. law generally exempt interest from current taxation to the extent of penalties realizable, but unrealized, for early withdrawal.

Thus, unless deferral is permitted by treaty, interest accruing to the RRSPs of U.S. residents or citizens (and other savings tax-deferred under Canadian law) is taxable currently in the United States. By comparison, if the United States and Canada operated under consumption tax regimes, cross-border residents in either state would not require a treaty or special domestic law deferring the tax on interest, since the yield on all savings would effectively be tax-exempt.

²Canada-U.S. tax treaty, art. XXIX(5) (repealed by third protocol, art. 17, para. 2). RRSPs are retirement savings plans tax-deferred under Canadian domestic law. They are loosely analogous to Individual Retirement Accounts (IRAs) in the United States, though the contribution limits are generally higher for RRSPs.

³The exceptions, inapplicable here, provide various relief from the 50 percent U.S. ownership requirements that otherwise apply to companies. Art. XXIXA(3), (4), (6).

⁴Canada-U.S. tax treaty, art. XXIXA(1).

⁵Canada-U.S. tax treaty, art. XXIXA(2).

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for whom relief was intended, Canadian citizens resident in the United States, are excluded from relief.⁶

All recent U.S. tax treaties contain LOB articles.⁷ Those provisions are intended to prevent persons with nominal residence in a contracting state from capturing treaty benefits.⁸ In U.S. tax treaties this is typically accomplished by detailed rules that generally exclude nonpublicly traded companies less than half owned either by publicly traded companies, by individuals, or by a government entity, resident in one of the contracting states.⁹

The Canada-U.S. LOB article is unusual in that by its terms its detailed rules are solely for application by the United States.¹⁰ Most countries negotiating tax treaties with the U.S. simply accede to the U.S. demand for an LOB article containing detailed rules,¹¹ as it is generally understood that the U.S. Senate will not ratify a treaty without such a provision. It appears, however, that Canada took an unusually strong position when negotiating the third protocol. The technical explanation says that Canada did not want to rely on detailed technical rules for protection and instead preferred to rely on general abuse principles.¹² The apparent fear was that reliance on detailed rules in the LOB article might foreclose Canada from more flexible means of protection under general abuse principles with respect to other articles.

⁶See, technical explanation to the convention, third protocol, art. 9. The technical explanation is less than clear on the nature of the prior provision, and on its relationship to the new provision. While the technical explanation says that the prior rule applied only to "residents and citizens of the U.S. who are beneficiaries of RRSPs," the rule actually provided an election only for U.S. citizens residing in Canada to defer U.S. taxation of interest accruing on their RRSPs.

Also, the technical explanation states that the new rule "makes reciprocal the rule that it replaced and expands its scope." A reciprocal rule would provide Canadian citizens resident in the United States with relief against Canadian taxation of interest accruing on their IRAs and other savings tax-deferred under U.S. law. While the new treaty language supports such relief, this feature was probably unintended, though harmless, since Canada does not tax nonresidents on their worldwide income.

Finally, the technical explanation understates the scope of relief under the new treaty language when it says that the new rule allows deferral in the state of residence. Deferral in the state of citizenship is also permitted. But for this latter feature, the new treaty language would support neither the relief provided under the former rule nor its reciprocal.

⁷By "recent" the author means treaties either submitted within the last two decades or with a comprehensive protocol submitted within that time. The treaty with Indonesia may be the single exception. It was submitted in 1988, with a second protocol submitted in 1996. Neither the treaty nor the protocols contain the equivalent of a limitation article. However, the second protocol was far from comprehensive, addressing only reduced rates of withholding on interest, dividends, and royalties.

⁸See, Technical Explanation to U.S. Model Tax Treaty, art. 22.

⁹See, e.g., U.S. Model Tax Treaty, art. 22.

¹⁰Canada-U.S. tax treaty, art. XXIXA(1).

¹¹See, e.g., Germany-U.S. tax treaty. German treaties with other countries do not typically contain LOB articles. Exceptions are the Germany-Kuwait and Germany-U.A.E. treaties, which not only contain LOB articles, but "one-sided" articles at that: for the purpose of application only by Germany with respect to certain other articles. Notably, those LOB articles avoid the drafting problem of the Canada-U.S. LOB article by declining the ambitious task of splitting the universe between qualified and nonqualified persons.

The Germany-Kuwait treaty instead says that a resident of Kuwait is entitled to certain treaty benefits only if he is individual, the State of Kuwait or an entity thereof, or, generally, a company more than half owned by Kuwaiti residents or government entities. If there is no alternative to a one-sided limitation article, the narrower approach of the Germany-Kuwait LOB article is probably a better drafting example than that of the Canada-U.S. treaty.

¹²Technical explanation to third protocol, art. 18.

Recognizing that it was not possible for the United States to accept a treaty without an LOB article containing detailed rules, Canada agreed to sign on only if the treaty stated that the detailed rules were solely for the purpose of application by the United States, and only if it were further stated that Canada was relying solely on general abuse principles.¹³ The U.S. model treaty was not drafted for this kind of one-sided application, and no other U.S. treaty has a one-sided LOB article. The drafters therefore faced the novel task of reworking the neutral, model treaty language into the one-sided form needed to conclude the agreement. For the purpose of application, the drafters quite naturally focused on the manipulation of Canadian residence, since there is no concern that U.S. residence will be used to capture treaty benefits from the United States.

While understandably focusing on Canadian residence, the drafters apparently lost sight of the need for natural persons resident in the United States to claim benefits under the pensions article. Since the LOB article defines qualifying persons generically as residents of Canada, the treaty as drafted denies resident state relief to U.S. residents.¹⁴

The good news is that the U.S. competent authority is way ahead of the treaty. Revenue Procedure 2002-23, published in April 2002, provides a simple manner of electing benefits under paragraph 7 of the pensions article.¹⁵ The Revenue Procedure applies to natural persons with U.S. citizenship or residence who are beneficiaries of certain Canadian tax-deferred savings plans.¹⁶ Conversations with other counsel experienced in representing Canadian individuals resident in the United States confirm IRS practice of providing the relief inadvertently denied by the LOB article.

IRS practice is sound in this regard, since enforcing the LOB article as written would be embarrassing and contrary to the intent of the pensions article. However, the treaty itself should provide notice of what actual practice will be, and actual practice should not be contrary to the plain language of the treaty. As of the time this paper was researched, it was apparent that no fix was on the table for the fifth protocol, and further that there was neither U.S. nor Canadian awareness of the problem with the LOB article. However, Treasury sources indicate that the fifth protocol has not been signed, and that there is still time to negotiate an appropriate modification.

Before addressing the question of how another protocol might address the problem, we should take a moment to observe whether the inadvertent effect of the LOB article is restricted to paragraph 7 of the pensions article. Under the pensions article, Canadian source pensions, annuities, and benefits arising under the social security legislation in Canada (beneficially owned by a U.S. resident, or by a U.S. citizen not resident of Canada), are taxable in the United

¹³Canada-U.S. tax treaty, art. XXIXA(7); the technical explanation says that this was included at Canada's request.

¹⁴The LOB article leaves untouched relief against U.S. taxation of interest accruing in the RRSPs of U.S. citizens resident in Canada. Prior to the third protocol, this comparatively small category of relief had been provided by the convention. See note 2, *supra*.

¹⁵U.S. practitioners may note that Form 8833 is not required. This is consistent with Treasury reg. 1.6114-1(c)(1)(iii), which waives the treaty-based disclosure otherwise required by IRC 6114. The Secretary has statutory authority under IRC 6114(b) to waive the disclosure requirement for pensions-related relief. However, paragraph 7 of the pensions article still requires election by the taxpayer under competent authority rules.

¹⁶Revenue Procedure 2002-23, section 3. Under the Revenue Procedure, eligible plans include RRSPs, RRIFs, and registered pension and deferred profit sharing plans.

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States only to the extent they would be taxable under Canadian domestic law.¹⁷ This relief, too, is inadvertently reversed by the LOB article, which denies relief against U.S. taxation to anyone who is not a resident of Canada.

Because the problem resides in the LOB article and affects multiple provisions of the pensions article, it is probably a good idea to amend the LOB language itself so that any natural person is a "qualifying person" for the purpose of application of the treaty by the United States.¹⁸ This could be accomplished in more than one way. Negotiators could add another exception paragraph, such as those already listed in paragraph 1(b) of the article. More radically, they could eliminate paragraph 1, remove the Canadian residence requirement from the general introductory language of paragraph 2, and reinsert it to modify the companies, trusts, estates, and organizations that are the subject of sub-paragraphs (c)-(h).

There is some irony in the difference between Canadian and U.S. approaches to the problem. While at the time it negotiated the third protocol, Canada probably did not have highly developed domestic general abuse rules yet it took a strong position on wanting to rely solely on general abuse principles.¹⁹ On the other hand, the United States has relatively well-developed domestic general abuse principles, and yet it insists on placing detailed LOB rules in its tax treaties.²⁰

The OECD Commentary on "Improper Use of the Convention" under article 1 of the OECD Model Tax Convention has developed over several decades. The Commentary begins with the suggestion each state apply its domestic abuse principles as protection against claims of treaty benefits under nominal residence, and that contracting states may agree to preserve such domestic rules for application in their treaties.²¹ A later comment reveals some of the complexity inherent in this suggestion. The OECD Committee on Fiscal Affairs acknowledges differences over whether general abuse principles are implied in treaties (majority view), or whether they need to be explicitly stated (dissenting view).²² If implied, from where do such principles derive?²³

¹⁷Canada-U.S. tax treaty, art. XVIII(1), (5)(b).

¹⁸The residence rules and scope of coverage addressed in articles I and IV are adequate to limit benefits for natural persons.

¹⁹David A. Ward, *Abuse of Tax Treaties*, 397, 402, 1993 festschrift for Sydney Roberts, ed. Kees van Raad (discussing a 12-country study published in 1985 finding "a seeming absence . . . of anti-abuse principles in the tax law of Belgium, Canada and Italy").

²⁰While there is no overarching general abuse doctrine in U.S. tax law, a variety of judicial doctrines, statutory enactments, and regulations have created a somewhat *ad hoc* though imposing network of obstacles to aggressive tax planning. Some examples include sham transaction and step transaction doctrines, substance over form, economic substance and business purpose tests. Judicial development of the business purpose test is often thought to have begun with *Gregory v. Helvering* (S. Ct. 1935) and has long been incorporated by statute and regulation throughout subchapter C of the Internal Revenue Code (governing corporate distributions and reorganizations). *E.g.*, Treas. reg. 1.355-2(b). *See also*, IRC 269 (conferring authority to Treasury to disallow deduction or credit obtained through certain corporate acquisitions or liquidations where principle purpose of transaction is tax avoidance). More recently, the partnership antiabuse regulations have adopted business purpose and substance over form principles. Treas. reg. 1.701-2 (asserting IRS authority to recharacterize a partnership if formed mainly to reduce tax liability in a way not intended by the Internal Revenue Code).

²¹Paragraph 7 of Commentary to article 1 of OECD Model Tax Convention.

²²*Id.* at para 24.

²³*See generally*, Ward, *supra*.

It is beyond the scope of this article to discuss whether it is better to rely on general abuse principles or detailed rules — or, if general principles are preferable, how such principles might be derived. But given the background of strong and persistent differences of opinion on this point, it may be useful to ask what should be done when these opinions directly collide during treaty negotiation. The possibilities include concession or compromise. Is it possible to decide which is better as a general matter? Judging by the consistency of U.S. treaties with states that do not typically deploy detailed LOB rules, there would appear to be some consensus favoring concession over compromise.²⁴

While it would be unfair to suggest that the drafting error in the Canada-U.S. LOB article, itself easily correctable, militates toward concession or disfavors the one-sided result arrived at as a compromise in the third protocol, our examination of the Canada-U.S. treaty does create an opportunity to ask whether the two contracting states are otherwise well-served by the compromise. Under the Canada-U.S. LOB article, the United States asserts the protection of general abuse principles in addition to the protection of its detailed rules.²⁵ But the U.S. reliance on detailed rules seems to undermine its assertion of general principles. Canada appears to have avoided the problem by eschewing detailed rules, so that it has, in effect, bargained for more protection than the United States. But has it? By agreeing that the United States has the protection of both general principles and detailed rules, Canada may have opened itself to the argument that Canada bargained for a lower level of protection — so that the U.S. detailed rules, for want of a better guide, should be used to define the upper limit of Canada's protection.

The argument would be that while entitled to assert general principles, Canada could not use those principles to deny relief to a company that could pass muster under the U.S. detailed rules. Were this argument to succeed, Canada may yet have protected itself from presumptions against the application of general abuse principles with respect to other articles, but would have gained nothing in the limitation article over simple concession to the U.S. model language. These potential problems, not yet juridically tested, raise some doubt as to whether either U.S. or Canadian interests are well-served by the one-sided approach, and, in general, whether a one-sided approach effectively accommodates divergent positions rather than tending to undermine one or both.²⁶ Of course, the political reality that the U.S. is not going to concede on the limitation issue means that if concession is a better result than compromise, the result will be a limitation article with detailed rules based on the U.S. model, with no talk of general principles. Again, international consensus points to this result. If there really is a problem with the U.S. limitations approach, perhaps it is time to reinvigorate the discussion over general abuse principles in a multilateral setting. ♦

²⁴The treaty with Canada is the only U.S. tax treaty where the detailed rules are only for application by the United States.

²⁵Canada-U.S. tax treaty, art. XXIXA(7).

²⁶*C.f.*, RMM, Equilease, Tax Ct. of Canada, Lexis 1384, pp. 57-8 (1997), a dividend-stripping case where the Tax Court of Canada found that Canada's reservation in para. 7 of the LOB article of the right to apply general abuse principles "could not prevent Canada from applying GAAR to recharacterize the transaction [under Canada's antiabuse law]" (emphasis added). The court's reasoning here, the last of several grounds supporting the result, provides weak support at best for any positive effect of Canada's reservation in para. 7.

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