

# The U.S. TAXFAX

**TOPIC: PROTOCOL TO THE CANADA-U.S.  
INCOME TAX CONVENTION (1980)**

**Date of Issue: November of 1996**

This issue of the U.S. TAXFAX discusses the changes to the Canada - U.S. tax treaty as a result of a protocol ratified on November 8, 1995. The changes to the treaty will become effective January 1, 1996 with the exception of the provisions dealing with death taxes.

## **WITHHOLDING TAXES**

**DIVIDENDS:** The treaty reduces the maximum withholding rates that may be charged on certain crossborder payments. A company that owned at least 10% of the voting stock of a company resident in the other jurisdiction was subject to withholding tax on dividends of 10% prior to the protocol. The protocol reduces this rate to 6% for dividends paid in 1996 and 5% for those paid thereafter.

**INTEREST:** The protocol also reduces the withholding rates on cross-border interest payments. Withholding on interest payments will be reduced from 15% to 10% as of January 1, 1996.

**ROYALTIES:** Under the pre-protocol treaty, many royalties and like payments were exempt from withholding tax and taxed only in the country in which the recipient was resident. Payments in respect of the production or reproduction of any literary, dramatic, musical or artistic work (but not including royalties in respect of motion pictures and works on film, videotape, or other means of reproduction for use in connection with television) were exempt from withholding. The protocol expands the list

of exempt payments to include payments for the rights to use the following:

- computer software,
- any patent or any information concerning industrial, commercial, or scientific experience (not including information with respect to a rental or franchise agreement)
- broadcasting (details of this category are to be worked out later)

The reduced withholding rates and additional royalty exemptions become effective on January 1, 1996. Companies should review their current cross-border arrangements to determine whether they can take advantage of the changes brought on by the protocol. It should be noted that there are other issues besides withholding taxes that need to be considered when repatriating profits. Two of these issues are the earnings stripping and thin capitalization rules that will be discussed in future editions of the U.S. TAXFAX.

## **TAXES IMPOSED BY REASON OF DEATH**

The addition of Article XXIX to the treaty is by far the most important change brought on by the protocol. In the past it was possible for a taxpayer to pay estate taxes to the U.S. and income taxes to Canada on the same property. The taxes were not creditable against each other and thus tax liabilities on death could exceed 80%. The protocol has addressed the above problem in the following manner.

U.S. estate taxes will be deemed an income tax for purposes of calculating the foreign tax credit in Canada on the terminal return. Similarly, U.S. citizens and residents will be able to claim a

credit on their estate tax returns for income taxes paid to Canada on the deemed disposition at death of property located in Canada.

The United States will also allow Canadians an increased credit against estate taxes owing. U.S. citizens are presently allowed a credit of U.S.\$192,800 against their estate tax liability on their worldwide assets. This credit shelters the first U.S.\$600,000 of the U.S. citizen's taxable estate. Canadians are now allowed a credit equal to the greater of:

- U.S. assets relative to worldwide assets multiplied by the U.S.\$192,800 unified credit; and
- The minimum unified credit currently allowed to U.S. non-residents or U.S.\$13,000

This credit will be reduced by the amount of any credit previously allowed with respect to any taxable U.S. gifts made by the Canadian during his lifetime. As a result, if a Canadian's gross worldwide estate is less than U.S.\$600,000 he will no longer have to pay any U.S. estate taxes. The protocol also provides an additional credit if property is left to a surviving spouse. This additional credit will defer any estate tax payable until the death of the surviving spouse. This deferral reduces the usefulness of the qualified domestic trust presently used by many Canadians who own U.S. property.

The protocol also provides that if an individual's worldwide estate is less than U.S.\$1,200,000 they will be exempt from U.S. estate tax on any U.S. property if the gain from an actual disposition of this property would have been exempt. This generally means that investments in U.S. stocks, other than U.S. real property holding corporation, or bonds are exempt from estate tax while investments in real estate is not.

A non resident estate will still have a U.S. filing requirement if its gross U.S. assets are greater than U.S.\$60,000. It must file Form 706NA, Estate Tax Return, along with a treaty disclosure statement. This statement sets out the facts relied upon in support of the taxpayers position that the estate is not taxable because of the additional credit made available by the protocol.

The IRS also requires substantial documentation verifying worldwide assets for any estate required to file. This documentation includes the will, foreign tax returns, and a copy of the probate documents.

The effective date for the provisions relating to U.S. estate tax is retroactively for deaths occurring after November 10, 1988. Executors will have one year from November 8, 1995 to file refund claims with either or both the IRS and Revenue Canada.

### OTHER CHANGES

Social Security Benefits: The taxation of social security benefits (ie. Canada Pension Plan, Old Age Pension Benefits and U.S. social security payments) will change from being taxed only in the country of residence to being taxed only in the country of source.

Foreign Tax Credits: The protocol provides that U.S. social security taxes will qualify for the Canadian foreign tax credit.

The protocol also sets out that a review of the treaty will be undertaken within three years from the date of the protocol. This review will look at further reducing withholding rates and address whether any other amendments in the treaty are necessary.

The above analysis of the protocol is not comprehensive. We have reviewed the changes which we feel will have the greatest effect on cross border relations. The U.S. TAXFAX will constantly be referring to the treaty and thus all sections of the new treaty will be discussed in future editions.

Please remember, the information presented is general in nature and does not constitute professional advice. It is recommended that accounting, legal or other professional advice should be sought before acting upon any of the information contained.