Canada-US Tax Treaty

General

The first treaty between Canada and the US went into effect in 1942; this treaty was replaced in 1980. The 1980 Treaty has been amended five times through protocols, with the last protocol being signed in September 2007.

The question everyone has is "what is the relationship between a country's tax laws and the treaty?" In Canada, the Treaty generally forms part of the law of Canada upon enactment and subject to the provisions of the Income Tax Conventions Interpretation Act (ITCIA), the Treaty prevails over the Income Tax Act, only to the extent of inconsistency. Under American law, the Constitution treats tax treaties on equal footing with US domestic law; both are "the supreme law of the land." A longstanding principle of American jurisprudence has been that if a treaty conflicts with a Federal law, the later in time will prevail.

There are three main purposes for the Treaty; 1) elimination of double tax, 2) information sharing, and 3) to provide assistance in collecting tax.

The Treaty applies to income taxes and does not cover unemployment tax, social security tax, excise tax, or taxes imposed by States or Provinces. There is a separate treaty that covers social security taxes; it is sometimes referred to as the Totalization Agreement. We will not be discussing this agreement.

Residency

Part of eliminating double tax is determining which country gets to tax what income. One significant way this is done is by determining your personal residency and whether your business has a "permanent establishment" in the country.

Residency under the Treaty is based on whether a person is considered a resident of a country under the laws of that country. If a person is a resident of only country under domestic law, there is no need to look further. However, if the person is a resident of both countries under domestic law, then the Treaty will use tie-breaker rules to determine residency.

It is important to note that the tie-breaker rules must be analyzed in a hierarchical basis. You must start with the first factor and only if that factor is not conclusive, would you move on to the second factor, and so on. The factors are:

1. Is there a **permanent home** available to you?
   a. Any kind of dwelling whether owned or rented.
   b. If you rent the dwelling to an unrelated person, the dwelling is not considered available.

2. In which country do you have **closer personal and economic relations**, i.e. center of vital interests?

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a. Employment with an employer
b. Active involvement in a business
c. Bank accounts, securities accounts or retirement plans
d. Location of personal property
e. Memberships in professional or religious organizations
f. Location of family members
g. Based on an extended period of time, not just period of dual residency

3. In which country is your **habitual abode**?
   a. Days spent in the country is the most important factor

4. In which country are you a **citizen** of?

5. If you are a citizen of both countries or of neither country, then **competent authority** will settle the question by mutual agreement.

Competent authority is the appropriate governmental entities of each country.

Permanent establishment means a fixed place of business through which a business is wholly or partly carried on. The term "permanent establishment" specifically includes:

- A place of management;
- A branch;
- An office;
- A factory;
- A workshop;
- A factory; and
- A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

A building site or construction project constitutes a permanent establishment if, and only if, it lasts more than 12 months.

A permanent establishment does not exist if engaged in one or more of these activities:

- Facilities are used for storage;
- Maintenance of the goods or merchandise used for storage;
- Maintenance of goods or merchandise for the purpose of "processing" for another person;
- The purchase of goods or merchandise; and
- Advertising or supply of information

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Withholding

Generally, Canada requires withholding of 25% on income paid to a nonresident and the US generally imposes a 30% withholding tax. The Treaty provides for reduced withholding on many types of income. Examples are:

- Interest – 0% on most types of interest payments
- Dividends – 15% unless the dividend is paid to a parent corporation in the other country that owns at least 10% of the voting shares, then the withholding rate is 5%.
- Pensions – 15%

Death Taxes

The purpose of the article of the Treaty is to coordinate the death taxes of the two countries. Without the Treaty, there would be double tax because Canadian's death tax is an income tax and the US death tax is an estate tax (tax on assets) so barring the Treaty, there would be no way to take a foreign tax credit or otherwise eliminate double tax.

US death taxes include estate, gift and generation-skipping transfer tax. It does not include state death taxes.

The US estate tax system provides an exemption from tax on the first US$5,430,000 of net assets. That exemption is referred to as the Applicable Exclusion Amount (AEA). The Treaty provides a pro rata Applicable Exclusion Amount equal to the deceased's US assets, divided by worldwide assets, times the AEA (US$5,430,000 per person in 2015 and indexed for inflation) and will no event be less than US$60,000.

The Treaty also provides a special Martial Credit allowance for transfers to spouses. The deceased is allowed a doubling of the amount from above, if:

- The property passing is "qualifying property."
- Decedent must have been a resident of either Canada or the US, or a Canadian or US citizen at the time of death.
- The surviving spouse must have been a resident of either Canada or the US, or a Canadian or US citizen at the time of the decedent's death.
- If both the decedent and the spouse were residents of the US at death, at least one of them has to be a Canadian citizen.
- Must irrevocably waive the benefits of the unlimited marital deduction.

Canada agrees to give Canadian residents that are not US citizens or green card holders a credit for US federal and state inheritance tax on US property. This credit is allowed against Canadian tax paid. The US agrees to give credit against federal estate for Canadian federal and provincial income taxes imposed at death.

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In summary, this means that if you have worldwide assets that are less than the AEA (US$5,430,000 in 2015 or US$10,860,000 for a couple), there will be no US estate tax. If however, your worldwide assets exceed the AEA, you could be subject to US nonresident estate tax.

Let's take an easy example. You are single and your worldwide assets are equal to US$10,000,000. Included in the US$10,000,000 is a home you own in your own name in Florida that is worth US$1,000,000. You would be able to exclude US$5,430,000 times US assets over worldwide assets, or 1,000,000/10,000,000, or 10%. Ten percent of $5,430,000 is $543,000. So $543,000 would be excluded and you would owe tax on $457,000. If you were married to a Canadian, the entire amount would be excluded and there would be not tax.

Note: There are planning techniques that can be used prior to death that could prevent the house, in this example, from being included as a US asset and therefore not subject to nonresident estate tax. Also, any tax you pay in the US can be taken as a credit against your final Canadian income tax.

Note: That as long as the assets are considered US assets and the total US assets exceed $60,000, you must file a US estate tax return. The practical explanation as to why you will have to file a US estate tax return is quite obvious, you are claiming that your worldwide assets are less than the AEA; the IRS is not simply going to take your word for it, they will need you to provide substantiation and a signed return claiming the amounts to be true.

Final comment

The last thing to note is that if you are using any provision of the Treaty to alter the tax that would otherwise be owed under domestic law, you must file a return and disclose the fact you are using a provision of the Treaty to reduce your tax. As explained above in the estate tax example, just because you have no tax due, does not mean that you have no tax return due.

Resources:

Tax Treaty

- Convention Between Canada and the United States of America
- Information on the United States-Canada Income Tax Treaty

Social Security Treaty

- US-Canada Agreement on Social Security – The Agreement
- US-Canada Agreement on Social Security – Pamphlet
- Windfall Elimination Provision – Pamphlet
- Windfall Elimination Provision – Commentary

Book - The Border Guide

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