

The Relationship Between Tax Treaties and the Income Tax Act: Cherry Picking

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PRÉCIS

La plupart des conventions fiscales ne servent pas à lever un impôt; elles permettent de limiter l'impôt levé par ailleurs par les pays contractants. Le Canada et les États-Unis ont adopté une disposition dans la plupart de leurs conventions fiscales, désignée comme une «disposition sur les avantages relatifs à l'impôt intérieur» dans laquelle ce principe est codifié. Selon cette disposition les dispositions contenues dans une convention ne limitent d'aucune façon le droit d'un contribuable à des déductions, à des crédits, à des exemptions, à des exclusions ou à d'autres allocations accordées en vertu d'une loi fiscale intérieure. La disposition sur les avantages relatifs à l'impôt intérieur est peu connue. Aucune cause au Canada n'a porté sur le sujet et peu de prises de positions administratives en ont traité.

Les dispositions sur les avantages relatifs à l'impôt intérieur contenues dans les conventions fiscales du Canada et des États-Unis sont examinées dans cet article. L'application de la règle canadienne à plusieurs situations précises y est analysée et des principes généraux préliminaires ou des lignes directrices en vue de l'interprétation ou de l'application y sont suggérés.

ABSTRACT

Most income tax treaties do not impose tax; they limit the tax otherwise imposed by the treaty countries. Canada and the United States have adopted a provision in most of their tax treaties, referred to as a "domestic tax benefit provision," that codifies this principle. According to the domestic tax benefit provision, nothing in a treaty restricts a taxpayer's entitlement to deductions, credits, exemptions, exclusions, or other allowances available under domestic tax law. Little is known about the domestic tax benefit provision. There are no Canadian cases and few administrative pronouncements dealing with it.

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This article surveys the domestic tax benefit provisions of Canadian and US income tax treaties. It analyzes the application of the Canadian rule in several specific situations and suggests tentative general principles or guidelines for its interpretation or application.

INTRODUCTION

It is well established in Canada and most other countries that tax treaties do not impose tax. The Supreme Court of Canada reiterated this principle in the *Melford Developments* case:

It is well to remind ourselves in analyzing these statutes and the subtended tax Agreement that the international Agreement does not itself levy taxes but simply authorizes the contracting parties, within the terms of the Agreement, to do so.¹

Similarly, Klaus Vogel, in his treatise on double taxation conventions, states, "It is a widely recognized principle of treaty law that DTCs [double taxation conventions] rather than being capable of creating new tax liabilities, can do no more than restrict existing ones."²

This principle is reinforced in virtually all of Canada's tax treaties by a miscellaneous rule, referred to in this article as the "domestic tax benefit provision," which states that a taxpayer will not be denied any domestic exemption, exclusion, credit, deduction, or other allowance as a result of the application of the treaty.³ In principle, this provision establishes that a taxpayer cannot be treated less favourably under a treaty than the taxpayer would have been treated under the laws and treaties of the country if the treaty had not come into existence. In other words, where the provisions of a treaty and the provisions of domestic law both apply to a taxpayer, the taxpayer is entitled to the more favourable result. Another way of expressing this general principle is to say that tax treaties are exclusively relieving in nature.⁴

¹ *The Queen v. Melford Developments Inc.*, 82 DTC 6281, at 6285; [1982] CTC 330, at 335 (SCC).

² Klaus Vogel, *Klaus Vogel on Double Taxation Conventions* (Deventer, the Netherlands: Kluwer, 1991), 75-76.

³ The provision is usually found in the section of the treaty entitled "Miscellaneous Rules"; however, the number of the provision varies from treaty to treaty. There are also minor differences in the wording of the provision in some treaties, which are referred to later in this article. Since Canada does not have a published model tax treaty, there is no official version of the provision to which reference can be made. The OECD model treaty, *infra* footnote 16, does not contain any comparable provision.

⁴ This paraphrase may not be completely accurate because, for example, an exchange of information pursuant to a treaty may result in a taxpayer's paying more domestic tax than the taxpayer would pay if the treaty were not in existence. However, while exchange of information affects the enforcement of tax payable, it does not affect the liability for tax.

There may be situations in which the provisions of a treaty result indirectly in the imposition of more tax than if the treaty were ignored. For example, article XIX of the
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Beyond widespread recognition of this general principle, the meaning and significance of the domestic tax benefit provision have not been explored in Canada. There have been no court cases interpreting or applying the provision, and neither the Department of Finance nor Revenue Canada has issued any pronouncements concerning its meaning. There is only a brief reference to the provision in the technical explanation of the Canada-US treaty,⁵ and an unsupported assertion in the technical explanation of the 1995 protocol to the treaty that “the prohibition against so-called ‘cherry-picking’” is “a basic principle of tax treaty interpretation recognized by both Contracting States.”⁶ The provision has not been analyzed in detail in the literature on Canadian tax treaties.⁷

⁴ Continued . . .

Canada-US tax treaty provides that remuneration paid by a country to a citizen of the country for services of a governmental nature are taxable only by that country and not by the other country even if the citizen performs the services and is resident in the other country: The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, and March 17, 1995 (herein referred to as “the Canada-US treaty”). Under paragraph 115(2)(e) of the Income Tax Act, a non-resident individual is subject to Canadian tax on employment income received directly or indirectly from a resident of Canada for services performed outside Canada if the income is subject to foreign tax: Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). A Canadian citizen and former resident of Canada who is currently resident in the United States and receives employment income from the government of Canada is subject to Canadian tax on the income because the income is not taxable in the United States by virtue of article XIX of the treaty. In the absence of the treaty, the taxpayer would not be subject to any Canadian tax on the income.

This example does not stand for the proposition that treaties can impose tax in certain circumstances. At most, it illustrates a situation in which a Canadian tax rule depends or is conditional on the foreign tax consequences, which in turn are dependent on the application of the treaty. In effect, the tax is imposed exclusively by the domestic legislation, which for this purpose incorporates the effect of the treaty. This analysis is supported by the technical structure of subsection 115(2). The liability for tax is imposed by paragraph 115(2)(c). Paragraph 115(2)(c), which incorporates the effect of treaties, determines the quantum of income subject to Canadian tax.

I am indebted to Jacques Sasseville for this example.

⁵ United States, Treasury Department, Technical Explanation of the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, April 26, 1984, article XXIX.

⁶ United States, Treasury Department, Technical Explanation of the Protocol Amending the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital (June 13, 1995). In the Department of Finance, *Release*, no. 95-48, June 13, 1995, the minister of finance stated that Canada accepted the US technical explanation as the proper interpretation of the provisions of the protocol. Although there is no authority for the statement in the technical explanation, it may carry significant weight in any cherry-picking case because it represents the intention of both parties to the treaty.

⁷ At a special conference of the International Fiscal Association in 1979, out of 392 pages of papers delivered, only two brief paragraphs dealt with the domestic tax benefit provision. See E. Cal Cochrane, “Other Areas,” in International Fiscal Association, Canadian Branch, *Special Seminar on Analysis of Canada’s Tax Conventions and Comparison to the O.E.C.D. Model Double Taxation Convention* (Toronto: De Boo, 1979), 389-92, at (The footnote is continued on the next page.)

A similar domestic tax benefit provision is included in virtually all US tax treaties. In the United States too, the provision has received little attention, though it has been applied in one case⁸ and in a few administrative rulings. Generally, the US literature examining the provision is skimpy. However, in 1992, the American Law Institute (ALI) published a study of US income tax treaties,⁹ which enunciated some principles for the application of the provision.

This article analyzes the domestic tax benefit provision in Canadian tax treaties. It begins with a discussion of the general relationship between tax treaties and domestic tax law in order to provide some context and background for the subsequent analysis. Following a brief description of the genesis of the rule, there is a survey of the domestic tax benefit provisions of Canadian and US tax treaties. Other countries do not habitually include a similar provision in their tax treaties, although they seem to have little difficulty in accepting its inclusion in their treaties with Canada and the United States. The most important part of the article is devoted to an analysis of the application of the domestic tax benefit rule in various circumstances. From this analysis, I have derived some tentative principles concerning the application of the rule.

THE RELATIONSHIP BETWEEN TAX TREATIES AND DOMESTIC TAX LAW

The relationship between Canadian tax treaties and the Canadian Income Tax Act¹⁰ is more complicated than it at first appears.

Until enacted as a statute of the government of Canada, a tax treaty does not confer any rights on taxpayers. A treaty is an agreement of the government of Canada with another sovereign state, which binds the two governments as a matter of international law. Each treaty is enacted by Parliament pursuant to an implementing act that approves the treaty and declares it to have the force of law in Canada.¹¹ Furthermore, each implementing act contains a provision, along the following lines, giving the treaty priority over any inconsistent Canadian law:

⁷ Continued . . .

389. The provision is not mentioned in Jean-Marc Déry and David A. Ward, "Canada," in *Cahiers de droit fiscal international*, vol. 78a, *Interpretation of Double Taxation Conventions* (Deventer, the Netherlands: Kluwer, 1993), 259-89.

⁸ *Emily St. A. Tait Est.*, 9 TCM 122 (1949).

⁹ American Law Institute, *International Aspects of United States Income Taxation II: Proposals on United States Income Tax Treaties*, Hugh J. Ault and David R. Tillinghast, reporters (Philadelphia: American Law Institute, 1992), 80-83 (herein referred to as "the ALI study"). My interest in the subject has its origin in the ALI study, and this article relies substantially on the analysis in the study. See also Stephen M. Brecher, "Relationship of, and Conflicts Between Income Tax Treaties and the Internal Revenue Code" (April 1972), 24 *The Tax Executive* 175-97.

¹⁰ *Supra* footnote 4.

¹¹ See, for example, section 3(1) of the Canada-United States Tax Convention Act, 1984, SC 1984, c. 20.

In the event of any inconsistency between the provisions of this Act or the Convention, and the provisions of any other law, the provisions of this Act and the Convention prevail to the extent of the inconsistency.

In the absence of this rule, a treaty would be just another statute, and conflicts between statutes that could not otherwise be resolved would be settled by giving priority to the statute that was later in time. However, the granting of priority to the treaty is not an absolute rule. Since Parliament is supreme (subject to the constitutional division of powers and the Charter of Rights and Freedoms), it can enact legislation that overrides the provisions of a tax treaty. Generally, however, if Parliament chooses to enact such overriding legislation, the Canadian courts will require it to do so explicitly, in recognition of the fact that treaties are international obligations that are entitled to appropriate respect.¹² The Income Tax Conventions Interpretation Act,¹³ which was enacted in 1985 to reverse the result in the *Melford Developments* case, provides expressly in four sections that the law in Canada shall be determined “notwithstanding the provisions of a convention or the Act giving the convention the force of law in Canada.”¹⁴ In these four instances, the Canadian government has enacted legislation that overrides its tax treaties. It must be recognized, however, that the Income Tax Conventions Interpretation Act represented an attempt to bring the interpretation of Canada’s tax treaties into line with international practice.¹⁵

In summary, Canadian tax treaties prevail over the provisions of the Income Tax Act to the extent of any inconsistency, subject to the provisions of the Income Tax Conventions Interpretation Act. This general principle concerning the relationship between tax treaties and the Income Tax Act is well established and well known. Less well known is the principle underlying the domestic tax benefit rule that a tax treaty shall not be applied to deprive a taxpayer of any benefit otherwise available under domestic tax law. These two general principles are not inconsistent, nor is there any obvious hierarchy between them. According to the second principle, if the treaty is less favourable to the taxpayer than the Act, the Act applies; therefore, there can be no conflict between the Act and the treaty. According to the first principle, on the other hand, the treaty prevails over any inconsistent provision of the Act, but only to reduce, not to increase, the tax burden on the taxpayer.

In addition to these two general principles, the relationship between tax treaties and the Act is governed by a series of specific rules, both in

¹² Article 26 of the Vienna Convention on the Law of Treaties, 1155 UNTS 331; UN Doc. A/Conf. 39/27, 289 (1969), to which Canada is a signatory, provides that “treaties are binding on the parties and shall be performed by them in good faith.”

¹³ RSC 1985, c. I-4, as amended.

¹⁴ *Ibid.*, sections 3, 4, 5, and 6.2.

¹⁵ See, generally, Janice McCart and Bernard Morris, “The Income Tax Conventions Interpretation Act—Unilateral Treaty Amendment? (Part I),” *International Tax Planning* feature (1983), vol. 31, no. 6 *Canadian Tax Journal* 1022-41, at 1025.

tax treaties and in the Act. Most tax treaties contain a number of rules that require the meaning of terms in the treaty to be determined in accordance with the domestic law of one of the contracting states. For example, article 6(2) of the OECD model treaty¹⁶ requires the term “immovable property” to be determined under the law of the contracting state in which the property is located. More generally, article 3(2) of the model treaty provides that any undefined terms in the treaty have the meaning that they have under the domestic law of the country applying the treaty unless the context otherwise requires.¹⁷ Because the language of tax treaties is very general, it seems inevitable that recourse must be had to the domestic laws of the contracting states in order to provide flesh for the bare bones of the treaty. At the same time, at least in Canada, treaties can affect the application of domestic tax laws. In a few instances, the provisions of the Act incorporate a treaty rule for domestic tax purposes.¹⁸ For example, under subsection 250(5) of the Act, a corporation that would otherwise be resident in Canada is deemed not to be resident in Canada if it is not resident in Canada pursuant to the provisions of a tax treaty. Therefore, if a corporation is a dual resident but the tie-breaker rule in the treaty makes the corporation a resident of the other country, the corporation is considered to be not resident in Canada both for purposes of the treaty and for purposes of the Act. Similarly, under the proposed amendments to the foreign affiliate regulations, a foreign affiliate is considered to be resident in a country only if it is resident in that country for the purposes of the treaty with that country.¹⁹

THE GENESIS OF THE RULE

The domestic tax benefit provision has its origins in early US tax treaty practice.²⁰ It appears that the provision was intended to express explicitly the principle that tax treaties are exclusively relieving in nature. However, the provision also has constitutional implications in the United States. Under the US constitution, revenue-raising bills must originate in the House of Representatives. Treaties are the responsibility of the president with the advice and consent of the Senate; the House of Representatives does not participate at all in the tax treaty process. If a tax treaty increased a taxpayer’s US tax liability, the constitutionality of the treaty would be subject

¹⁶ Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf).

¹⁷ See John F. Avery Jones et al., “The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model—I” [1984], no. 1 *British Tax Review* 14-54, and “. . . II” [1984], no. 2 *British Tax Review* 90-108.

¹⁸ See paragraph 110(1)(d.2), section 115.1, the definition of “earned income” in subsection 146(1), the definition of “compensation” in subsection 147.1(1), and subsection 250(5).

¹⁹ Canada, Department of Finance, Revised Draft Amendments to the Income Tax Act, January 1995, proposed regulation 5907(11.2).

²⁰ Klaus Vogel, Harry A. Shannon III, and Richard L. Doernberg, *United States Income Tax Treaties* (Deventer, the Netherlands: Kluwer, 1989), part II, commentary, at 23-28.

to challenge. The inclusion of the domestic tax benefit provision in virtually all US tax treaties precludes any such constitutional challenge.

A domestic tax benefit provision was included in the earliest US treaties with France²¹ and Sweden²² in 1939, and with Canada²³ in 1942. It is included in all but a few current US tax treaties and in the US Treasury Department's 1981 model tax treaty.²⁴

Canada entered into its first comprehensive income tax treaty, with the United States, on March 4, 1942. The treaty consisted of 22 articles and a simultaneous protocol, article 10 of which provided as follows:

The provisions of the present Convention shall not be construed to restrict in any manner any exemption, deduction, credit, or other allowance accorded by the laws of one of the Contracting States in the determination of the tax imposed by such State.

Apart from the 1942 treaty with the United States, most of Canada's early tax treaties did not contain any domestic tax benefit provision. The only tax treaties entered into before 1970 that included such a provision were those with the United States (1942), Germany (1956), Belgium (1958), Finland (1959), and Japan (1965). After the 1972 tax reform, however, the provision became a standard feature of Canadian tax treaties, based on the original US version with only minor modifications. It is understood that the domestic tax benefit rule is included in the unpublished Canadian model treaty.

It is difficult to explain or understand the widespread inclusion of the domestic tax benefit rule in Canada's current tax treaties. Initially adopted to conform to US practice, the rule apparently came to be incorporated into other treaties as an innocuous "motherhood"-type statement. The government never provided any public justification or rationale for its inclusion. Now, more than 50 years since its first appearance, it recurs in nearly 50 treaties. Perhaps it is not surprising that the rule is accepted without question.

SURVEY OF CANADIAN TAX TREATIES

As of June 1995, Canada had concluded bilateral tax treaties with 55 countries. Treaties with 2 other countries have been signed but not yet

²¹ Article 2 of the protocol to the Convention Between the United States of America and France for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Paris on July 25, 1939.

²² Article 2 of the protocol to the Convention Between the United States of America and Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Washington, DC on March 23, 1939.

²³ Article 11 of the protocol to the Convention and Protocol Between Canada and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion in the Case of Income Taxes, signed at Washington, DC on March 4, 1942.

²⁴ United States, Treasury Department, Model Income Tax Treaty, June 16, 1981, article 1(2). The only significant change from the early tax treaties is that the domestic tax benefit rule is now included in the articles of the treaty rather than in the protocol.

ratified.²⁵ Ten treaties do not contain any form of domestic tax benefit provision.²⁶ It is difficult to account for its omission from these treaties. The United States has treaties with 8 of the 10 countries, and 7 of these treaties have a domestic tax benefit provision; the treaty with Ireland is the only one that does not. This difference may reflect the United States' superior bargaining power in treaty negotiations. Alternatively, the provision may be omitted from more Canadian treaties because Canada does not attach the same significance to its inclusion as the United States does. The latter explanation seems more plausible, given the constitutional implications of the provision in the United States.

What may be described as the standard form of the domestic tax benefit provision in Canadian tax treaties reads as follows:

The provisions of this Convention shall not be construed to restrict in any manner any exclusion, deduction, exemption, credit, or other allowance accorded:

- a) by the laws of the Contracting State in the determination of the tax imposed by that State; or
- b) by any other agreement entered into by the Contracting State.

For analytical purposes, the provision can be broken down into two parts: the description of the domestic tax benefits covered and the scope of the benefits.

The standard description of the tax benefits is modified in a few treaties (Argentina, Czechoslovakia, Hungary, Mexico, and Zimbabwe) to delete the reference to an "exclusion." The Pakistan treaty adds the word "rebate" to the list of benefits. The treaties with China, Italy, and the USSR refer more generally to "tax benefit," "any tax allowance," and "more favourable tax treatment," respectively. In several treaties (Italy, Japan, Sweden, the USSR, and the US), there is a specific reference to domestic tax benefits "now or hereafter" provided by the contracting states. The additional words do not appear to add anything to the meaning of the provision. Even in their absence, the domestic tax benefit provision applies to all benefits, current or future, provided under domestic law.

With respect to the scope of the domestic tax benefit provision, the treaties reveal three approaches. In some treaties (India, Luxembourg, Malta, the UK, and the US), the provision applies to tax benefits "accorded by the laws of a Contracting State." In the other treaties, the provision also applies to tax benefits accorded pursuant to agreements between the contracting states or to any agreement to which one of the states is a party. The latter form of the provision is clearly broader. However, in some countries, including Canada, the reference to the laws of

²⁵ A treaty with Liberia was signed on November 11, 1976 but will not be ratified. The treaty with Nigeria was signed on August 4, 1992.

²⁶ These are the treaties with Australia, Denmark, France, Ireland, Kenya, the Netherlands, New Zealand, Norway, Singapore, and Trinidad and Tobago.

the state includes all of the country's treaties, since the treaties must be enacted as domestic laws before they confer any rights on taxpayers. Obviously, this is not the case in some countries, and an express reference to treaties is necessary. Several countries are unwilling to give taxpayers any benefits available under the country's other treaties. In the treaties with these countries, only benefits provided under domestic laws and agreements between the two countries are covered.

Table 1 provides detailed information about the domestic tax benefit provisions in Canada's existing treaties. It shows the date on which the treaty was ratified, provides the number of the domestic tax benefit provision, and identifies any variations in the wording of the provision from the standard wording set out above.

SURVEY OF US TAX TREATIES

The standard domestic tax benefit provision in US tax treaties is the same as the provision included in most of Canada's tax treaties. Article 1(2) of the 1981 US model treaty provides:

The Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded

- (a) by the laws of either Contracting State; or
- (b) by any other agreement between the Contracting States.

In contrast to Canada's treaties, there is little variation from this form in current US treaties. Moreover, only the treaties with Bermuda, Ireland, Pakistan, and the USSR do not contain a domestic tax benefit provision. Table 2 shows the date of ratification of each current US treaty, the number of the domestic tax benefit provision, and any variations from the standard wording.

OTHER COUNTRIES

Other countries do not include a domestic tax benefit provision in their tax treaties, other than their treaties with Canada and the United States. There is no such provision in the OECD model treaty, and the commentary on the treaty makes no mention of the principle embodied in the domestic tax benefit rule.²⁷ Other countries appear to be content to rely on the wide acceptance of that principle without converting it into an explicit and formally agreed-upon treaty provision.

THE APPLICATION OF THE DOMESTIC TAX BENEFIT RULE

Basic Principle

As explained earlier, the basic principle of the domestic tax benefit rule is that tax treaties do not impose tax; they are exclusively relieving in nature. Since it is widely accepted that this principle is inherent in tax

²⁷ Nor is the principle mentioned in Michael Edwardes-Ker, ed., *Tax Treaty Interpretation* (Dublin: In-Depth Publishing) (looseleaf).

**Table 1 Domestic Tax Benefit Provisions in Canadian Treaties
as of June 1, 1995**

Country	Date	Article	Variations from standard wording
Argentina	12/30/94	28(1)	—“exclusion” omitted —domestic laws and agreements with particular country
Australia	04/29/81	none	
Austria	12/19/80	XXVIII(1)	
Bangladesh	01/18/85	27(1)	—domestic laws and agreements with particular country
Barbados	12/22/80	XXX(1)	
Belgium	08/12/76	XXVIII(1)	
Brazil	12/23/85	protocol, para. 14	—domestic laws and agreements with particular country
Cameroon	06/16/88	25(1)	—domestic laws and agreements with particular country
China	12/29/86	protocol, para. 4	—“tax benefit”
Cyprus	09/03/85	29(1)	—domestic laws and agreements with particular country
Czechoslovakia	07/22/92	28(1)	—“exclusion” omitted —domestic laws and agreements with particular country
Denmark	09/28/56	none	
Dominican Republic	09/23/77	XXVIII(1)	—domestic laws and agreements with particular country
Egypt	10/02/84	27(1)	—domestic laws and agreements with particular country
Finland (1990)	08/20/92	27(1)	—domestic laws and agreements with particular country
France	07/29/76	none	
Germany	09/23/83	29(1)	—domestic laws and agreements with particular country
Guyana	05/04/87	25(1)	—domestic laws and agreements with particular country
Hungary	06/15/94	28(1)	—“exclusion” omitted —domestic laws and agreements with particular country
India	09/16/86	28(1)	—domestic laws
Indonesia	12/23/80	28(1)	—domestic laws and agreements with particular country
Ireland	12/06/67	none	
Israel	07/27/76	XXVIII(1)	
Italy	12/24/80	protocol, para. (j)	—“any tax allowance now or hereafter accorded” —domestic laws and agreements with particular country
Ivory Coast	12/19/85	XXVI(1)	—domestic laws and agreements with particular country
Jamaica	04/02/81	XXVIII(1)	

(The table is continued on the next page.)

Table 1 Continued

Country	Date	Article	Variations from standard wording
Japan	11/14/87	25(1)	
Kenya	01/08/87	none	
Korea	12/19/80	25(1)	—domestic laws and agreements with particular country
Liberia	NIF	XXVIII(1)	— domestic laws and agreements with particular country
Luxembourg	07/08/91	28(1)	—domestic laws
Malaysia	12/18/80	protocol, para. 5	—domestic laws and agreements with particular country
Malta	05/20/87	28(1)	—domestic laws
Mexico	05/11/92	27(1)	—“exclusion” omitted —domestic laws and agreements with particular country
Morocco	11/09/78	XXVII(1)	
Netherlands	08/21/87	none	
New Zealand	05/29/81	none	
Nigeria	NIF	protocol, para. 5	—domestic laws and agreements with particular country
Norway	08/24/67	none	
Pakistan	12/15/77	XXVIII(1)	—“rebate” added
Papua New Guinea	12/21/89	26(1)	—domestic laws and agreements with particular country
Philippines	12/21/77	XXVII(1)	—domestic laws and agreements with particular country
Poland	11/30/89	protocol, para. 7	—domestic laws and agreements with particular country
Romania	12/29/80	27(1)	—domestic laws and agreements with particular country
Singapore	09/23/77	none	
Spain	12/26/80	XXVIII(1)	—domestic laws and agreements with particular country
Sri Lanka	06/09/86	28(1)	—domestic laws and agreements with particular country
Sweden	10/30/84	28(1)	—domestic laws and agreements with particular country
Switzerland	08/19/77	XXVII(1)	—domestic laws and agreements with particular country
Thailand	07/16/85	27(1)	—domestic laws and agreements with particular country
Trinidad & Tobago	03/01/67	none	
Tunisia	12/04/84	XXVII(1)	—domestic laws and agreements with particular country
USSR	10/02/86	21	—“more favourable tax treatment now or hereafter accorded” —domestic laws and agreements with particular country
UK	12/17/80	27(1)	—domestic laws

(The table is concluded on the next page.)

Table 1 Concluded

Country	Date	Article	Variations from standard wording
US	08/16/84	XXIX(1)	—domestic laws
Zambia	12/28/89	XXVII(1)	—domestic laws and agreements with particular country
Zimbabwe	12/15/94	29(1)	—“exclusion” omitted —domestic laws and agreements with particular country

NIF = Treaty not in force

Table 2 Domestic Tax Benefit Provisions in US Treaties as of June 1, 1995

Country	Date	Article	Variations from standard wording
Argentina	NIF	1(2)	
Aruba	NIF	1(2)	
Australia	10/31/83	1(2)	—“rebate” added
Austria	01/01/57	XVIII(2)	—“exclusion” omitted —domestic laws
Bangladesh	NIF	26(2)	
Barbados	02/28/86	1(2)	
Belgium	09/13/72	28(2)	
Bermuda	12/02/88	none	
Brazil	N/A	3(2)	
British Virgin Islands	N/A	26(2)	—domestic laws
Canada	08/16/84	XXIX(1)	—domestic laws
China	11/21/86	protocol, para. 1	—“tax benefit”
Cyprus	12/31/85	4(2)	
Denmark	01/01/48	XXI(2)	—“exclusion” omitted —domestic laws
Egypt	12/31/81	6(2)	
Finland	12/30/90	1(2)	
France	08/11/68	22(3)	
Germany	08/21/91	protocol, para. 1(c)	
Greece	12/30/53	XVI(1)	—“exclusion” omitted —domestic laws
Hungary	09/18/79	24(2)	
Iceland	12/26/75	4(2)	
India	12/18/90	1(2)	
Indonesia	12/30/90	28(2)	
Ireland	12/20/51	none	
Israel	N/A	6(2)	
Italy	12/30/85	protocol, Article 3	
Jamaica	12/29/81	1(2)	
Japan	07/09/72	4(2)	
Korea	09/20/79	4(2)	

(The table is concluded on the next page.)

Table 2 Concluded

Country	Date	Article	Variations from standard wording
Luxembourg	12/22/64	XX(2)	
Malta	05/18/82	1(2)	
Mexico	12/28/93	1(2)	
Morocco	12/30/81	20(2)	
Netherlands	11/20/93	1(2)	—“by the laws of either state, except, as regards The Netherlands, with respect to Article 25 (Methods of Elimination of Double Taxation), or by any other agreement between the States”
Netherlands Antilles	N/A	1(2)	
New Zealand	11/02/83	1(2)	
Norway	12/15/81	22(2)	
Pakistan	05/21/59	none	
Philippines	10/16/82	6(2)	
Poland	07/22/76	5(2)	
Romania	02/26/76	4(2)	
Russian Federation	NIF	1(2)	
Spain	11/21/90	1(2)	
Sri Lanka	NIF	1(2)	
Sweden	01/01/40	protocol, 1939, para. 9	—“exclusion” omitted
Switzerland	01/01/51	XVIII(2)	—“exclusion” omitted —domestic laws
Thailand	NIF	21	
Trinidad & Tobago	12/30/70	3(2)	
Tunisia	12/26/90	22(1)	
USSR	12/30/75	none	
UK	03/25/80	27(2)	—domestic laws

treaties, it has been suggested that the inclusion of an express provision in Canadian tax treaties is simply “for greater certainty.”²⁸

One of the fundamental questions raised in this article is whether the results in specific situations (such as the cases discussed below) would be any different in the absence of a domestic tax benefit provision. The domestic tax benefit provision refers only to exclusions, exemptions, deductions, rebates, credits, or other allowances under domestic law. If a benefit is available under domestic law that is not covered by these words (perhaps in the form of a source rule or a status, for example), two questions arise. First, should the provision be interpreted broadly and liberally to include any aspect of domestic tax that results in less tax than

²⁸ See Cochrane, *supra* footnote 7, at 389.

the tax that results from the application of the treaty? In the United States, it has been suggested that the wording can and should bear such an expansive interpretation.²⁹ This approach may be less likely in Canada, where the interpretation of tax treaties is governed by the Vienna Convention³⁰ and the actual words used in a treaty provision cannot be easily ignored in favour of some underlying purpose. Second, even if the words of the provision cannot be interpreted so broadly, does the general principle that tax treaties are exclusively relieving in nature require the same result? If not, the domestic tax benefit rule operates, in effect, to restrict the underlying general principle.

As indicated earlier, the basic principle of the domestic tax benefit rule is not inconsistent with the general principle that the provisions of a tax treaty prevail over the provisions of the Act to the extent of any inconsistency. In effect, the provisions of a treaty prevail over inconsistent provisions of the Act unless the provisions of the Act are more favourable to the taxpayer. The situation is different where the provisions of Canadian domestic law override the provisions of the treaty pursuant to the Income Tax Conventions Interpretation Act. Here, the more favourable provisions of a treaty are denied to a taxpayer. If there is no clear statutory override of a treaty, however, and the provisions of the Income Tax Act are intended to be beneficial for taxpayers, it may be appropriate to provide the taxpayer with a choice between the Act and the treaty. Although this is apparently the practice in the United States,³¹ it represents a pragmatic solution³² rather than a principled decision concerning the resolution of the conflict between the domestic tax law and the treaty.

These issues concerning the basic principle of the domestic tax benefit rule have not been explored in Canada. Although they are interesting, the more important practical issues involve the consequences of the application of the rule in various circumstances. The basic principle of the domestic tax benefit rule seems innocuous and self-evident. The consequences of its application, however, are sometimes surprising and controversial. In particular, if the provisions of the treaty are applied for one purpose and the provisions of the Act are applied for another purpose, the taxpayer might be accused of taking inconsistent positions, or “cherry picking” between the Act and the treaty. These issues are explored in the following examples or cases, all of which are based on the Canada-US treaty.³³

²⁹ Vogel, Shannon, and Doernberg, *supra* footnote 20, part II, at 26.

³⁰ *Supra* footnote 12.

³¹ Brecher, *supra* footnote 9, at 191, and Internal Revenue Service, Rev. rul. 80-147, 1980-1 CB 168.

³² A taxpayer is unlikely to complain about whether the Act or the treaty applies if he gets to make the choice.

³³ *Supra* footnote 4.

The Basic Operation of the Domestic Tax Benefit Rule

Case 1

A US corporation receives interest from a Canadian resident corporation in respect of a long-term debt obligation. The interest is exempt from Canadian withholding tax under subparagraph 212(1)(b)(vii) of the Act. Under the provisions of the Canada-US treaty (article XI(2), as amended by the 1995 protocol), Canada is entitled to tax the interest at a rate not exceeding 10 percent and the United States is obliged to give a credit for the Canadian tax paid under article XXIV(1).

Applying the domestic tax benefit rule in these circumstances, it is obvious that the US corporation cannot be deprived of the benefit of the exemption under subparagraph 212(1)(b)(vii) because of the existence of the treaty. The US corporation's Canadian tax liability is determined exclusively under the Act; the treaty is irrelevant. In this case, there is no conflict between the Act and the treaty. Tax is imposed by the Act, not the treaty. The treaty is exclusively relieving; and in the situation described, there is no domestic tax from which to provide relief.

Double Benefits

Case 2

X, a Canadian resident individual, is employed in the United States for more than six months in connection with a construction project of X's Canadian resident employer. Under section 122.3 of the Act, in computing his Canadian tax payable, X is entitled to deduct up to 80 percent of the tax payable in respect of his US employment income. In effect, section 122.3 provides an exemption for certain foreign employment income up to a maximum of \$80,000 annually. Under article XXIV(2)(a) of the Canada-US treaty, Canada is obliged to give credit for any US taxes on US source income. X claims both the tax credit under section 122.3 and a treaty credit for the US tax paid on his US employment income.

Under the provisions of the Act, X is not entitled to more than one credit for foreign taxes paid on foreign employment income. While section 126 provides for a foreign tax credit in such situations, the definition of "non-business-income" tax in subsection 126(7) excludes the portion of any tax deducted under section 122.3. The question, therefore, is whether the taxpayer can claim the credit for his foreign employment income under section 122.3 of the Act and the credit for US tax under the treaty. In most situations dealing with the foreign tax credit, the treaty provides a clear answer. The credit available under article XXIV(2)(a) of the treaty is "[s]ubject to the provisions of the law of Canada regarding the deduction from tax payable in Canada of tax paid in a territory outside Canada and to any subsequent modification of those provisions (which shall not offset the general principle hereof)." Accordingly, the credit provided by the treaty is subject to the same limitations as the credit in section 126, including the exclusion of amounts claimed under section 122.3.

In a few of Canada's treaties, however, the credit provided by the treaty is not expressly required to be calculated in accordance with Canadian

tax rules.³⁴ With respect to these treaties, the issue concerning the application of the domestic tax benefit rule must be confronted. The taxpayer's argument is that nothing in the treaty denies the taxpayer's entitlement to the section 122.3 credit and the credit for the foreign tax also is available under the treaty. Although the treaty does not resolve the issue expressly, the result should be the same in this case because the taxpayer should not be able to duplicate benefits under the Act and the treaty. The purpose of both the credit under section 122.3 and the foreign tax credit under the treaty is to provide relief from double taxation, and the application of one or the other is sufficient for this purpose.

The same issue arises with respect to the deductions for foreign taxes under subsections 20(11) and (12) of the Act, as explored in the following case.

Case 3

X, a US citizen resident in Canada, is a shareholder of a corporation resident in the United States. X receives a dividend from the corporation that is included in X's income under section 90 of the Act. Under US tax law, the dividend from the US corporation is subject to US withholding tax of 30 percent (reduced by the treaty to 15 percent). Under subsection 20(12), X claims a deduction in computing his income for the 15 percent US withholding tax. In addition, X claims a credit against his Canadian tax payable for the US withholding tax pursuant to article XXIV(4)(a) of the treaty.

In this situation, the treaty does not expressly provide that the credit must be computed in accordance with Canadian tax rules. Under the definition of "non-business-income tax" in subsection 126(7), any amount deducted under subsection 20(12) is excluded from the amount of creditable foreign taxes. Although the taxpayer may argue that the domestic tax benefit rule applies to provide him with the deduction under subsection 20(12), it is clearly inappropriate for the taxpayer to have the benefit of both the statutory deduction and the credit under the treaty; they are alternative methods of relieving double taxation. In other words, the taxpayer should be entitled only to choose between the statutory deduction and the credit. Another way of looking at the issue, which has sometimes been used in the United States, is that the domestic tax benefit rule does not permit taxpayers to take inconsistent positions with respect to the treaty and the domestic tax legislation.³⁵ In this case, the credit provided under the treaty is based on the assumptions that the US income is taxable in Canada and that no other relief is available for the US taxes on that

³⁴ See Canada's treaties with Denmark (signed at Ottawa on September 30, 1955), article XIII(1); Brazil (signed at Brasilia on June 4, 1984), article 22(2); and Norway (signed at Ottawa on November 23, 1966), article 21(3).

³⁵ The technical explanation of article XXIX(1) of the Canada-US treaty, *supra* footnote 5, states, "Paragraph 1 does not . . . authorize a taxpayer to make inconsistent choices between rules of the Code and rules of the Convention."

income. These assumptions are consistent with the fundamental purpose of tax treaties, namely, to eliminate double taxation.

Therefore, in general, the domestic tax benefit rule should not be interpreted and applied to allow taxpayers to duplicate benefits accorded under the Act and a treaty where such benefits are alternatives. This position has been taken by the Internal Revenue Service (IRS) in the United States.³⁶

Source Rules

Case 4

A Canadian resident corporation receives royalties from the United States. The royalties are subject to US withholding tax at a statutory rate of 30 percent. Under article XII(3) of the treaty, however, the royalties are taxable only in Canada because they are copyright royalties paid by a resident of the United States. By virtue of article XXIV(3)(b), the royalties are considered to have their source in Canada because only Canada is entitled to tax them in accordance with the provisions of the treaty. In the absence of the treaty, the source of the royalties would be the United States.³⁷ Consequently, assuming that the taxpayer has other income from US sources, the royalties would be taken into account as foreign source income in calculating the limitation on the foreign tax credit under subparagraph 126(1)(b)(i) of the Act if the royalties are non-business income, or under subparagraph 126(2.1)(a)(i) if the royalties are business income; and the amount of creditable US tax would be increased accordingly.

The Canadian corporation argues that it is entitled not only to the exemption from US tax afforded by the treaty, but also to the treatment of the royalties as US source income for purposes of the foreign tax credit under section 126³⁸ because of the domestic tax benefit rule. More specifically, the argument is that the source rule in the treaty should not “restrict in any manner” the taxpayer’s entitlement to the foreign tax credit.

First, this argument should not be rejected on the basis that the source of income is not an exemption, exclusion, deduction, credit, or other allowance. The source of the income is an ingredient in calculating the foreign tax credit. The words “restrict in any manner” suggest that even indirect limits on a taxpayer’s access to an exclusion, exemption, deduction, credit, or other allowance should be covered. Indeed, in the United

³⁶ Rev. rul. 79-199, 1979-1 CB 246. Similarly, paragraph 110(1)(d.2) of the Act, dealing with shares received by a prospector or grubstaker, demonstrates a clear policy of preventing taxpayers from claiming benefits under both the Act and a treaty. Paragraph 110(1)(d.2) permits a prospector or grubstaker to deduct one-quarter of the amount included in income under section 35 unless the amount is exempt by treaty.

³⁷ See *Interpretation Bulletin* IT-270R2, February 11, 1991, paragraph 32.

³⁸ Amounts that are exempt from Canadian tax by treaty (that is, that are deductible in computing taxable income under subparagraph 110(1)(f)(i)) are excluded from the calculation of the limitation on the foreign tax credit. In this situation, however, the amount is not exempt from Canadian tax. It is taxable in Canada and is deemed to have its source in Canada under the treaty.

States it has been suggested that the wording of the domestic tax benefit provision, and in particular the phrase "other allowance," "should include any domestic tax provision, or combination of provisions, that yields a tax liability less than that which the treaty would generate."³⁹ Although the term "allowance" probably would be given a much narrower interpretation by Canadian courts,⁴⁰ the domestic tax benefit provision should be interpreted to cover indirect benefits such as source rules.⁴¹

Second, it also seems inappropriate to reject the argument on the basis that the source rules are administrative rather than statutory rules. Ultimately, the source of income is a question of law to be resolved by the courts.

Third, the purpose of the source rule in the treaty is to require the country of residence to give credit for tax paid to the country of source in accordance with the treaty. Thus, if the United States were entitled to impose a 10 percent tax on the royalties, the royalties would be considered to have their source in the United States by virtue of article XXIV(3)(b) and Canada would be obliged to give credit for the US tax. Where the source country is denied any right to tax, the residence country is under no obligation to provide any relief from double taxation. As a result, the royalties are treated as having their source in the country of residence.

The ALI study suggests that, although theoretically a taxpayer should be required to apply the source rules of the treaty where a treaty exemption is claimed, this approach is too complicated to work in practice.⁴² First, taxpayers would be required to determine whether statutory source rules were altered by a treaty. This obligation does not appear to involve any undue compliance burden for Canadian taxpayers since there are few statutory source rules. However, it might prove difficult for the tax authorities to audit the source rules used by a taxpayer. Second, according to the ALI study, it is incongruous to treat income as having a domestic source if it is exempt from foreign tax but as having a foreign source if it is subject to foreign tax, no matter what the rate. On the basis of these two factors, the ALI study concludes that taxpayers should be able to claim the exemption under the treaty and to apply the source rules of the domestic tax legislation. However, the technical explanation of the 1995

³⁹ Vogel, Shannon, and Doernberg, *supra* footnote 20, part II, at 26.

⁴⁰ Because the term "allowance" is not defined in the treaty, it must be given the meaning it has under Canadian law unless the context requires a different meaning (article III(2)). Under Canadian law, the term "allowance" refers to certain special deductions in computing income, such as capital cost allowance, depletion, and the resource allowance.

⁴¹ Similarly, domestic tax benefits resulting from a taxpayer's status as a resident should be covered, as discussed subsequently (see cases 15 and 16).

⁴² ALI study, *supra* footnote 9, at 84. See also Pamela B. Gann, "The Concept of an Independent Treaty Foreign Tax Credit" (Fall 1982), 38 *Tax Law Review* 1-78, at 27-28, in which the author argues, without referring to the domestic tax benefit rule, that a taxpayer must apply either the source rules in the treaty or the source rules in the Code in their entirety for the purpose of claiming the foreign tax credit under the Code. If, however, the credit is provided under the treaty and not the Code, the source rules in the treaty must be used.

protocol amending article XII of the treaty suggests that this combination of the treaty and domestic law is viewed as unacceptable cherry picking.⁴³

The question could also be asked with respect to this case whether the Canadian corporation has a choice between the treaty and the Act. In other words, could the corporation have chosen to ignore the treaty, pay the 30 percent US withholding tax, and treat the royalties as US source income? This question is raised more realistically in the following case.

Case 5

X, a resident of Canada, is employed in the United States for less than 183 days in a particular year and his remuneration is paid and borne by his Canadian resident employer. Under article XV(2) of the treaty, X's employment income is taxable only in Canada. Under article XXIV(3)(b), the source of the employment income is considered to be Canada, so that Canada is not obliged to give credit for any US tax on the income. For reasons of convenience, X chooses to pay US tax on his employment income and then claims credit for the tax in computing his Canadian tax payable.

X's choice is based on article XXIX(1) of the treaty, the domestic tax benefit provision. In effect, if the treaty were not in existence, X would pay tax in the United States and claim credit for the tax against Canadian tax payable. However, the total tax burden on X is the same whether or not the treaty applies.⁴⁴ The only effect of X's choice is how the tax is allocated between the two governments. Revenue Canada should take the position that the US tax paid by X is not creditable under section 126 because the tax is not paid in accordance with the treaty; in effect, it is a voluntary tax, which is not creditable. The domestic tax benefit provision, as applied by either Canada or the United States, does not allow the taxpayer to choose to pay more tax to the United States under the Code than it would pay under the treaty so that it can obtain a benefit under Canadian tax law.

The treaty bargain negotiated between the two countries with respect to article XV probably did not contemplate taxpayers having the choice of paying tax to the country of source where the treaty gives the exclusive right to tax to the country of residence. The domestic tax benefit rule allows a taxpayer to choose to be taxed under the domestic tax law where that law is more favourable. It does not allow the taxpayer to choose to be taxed less favourably under the foreign tax law in order to pay less tax—in other words, to choose where to pay tax.

⁴³ The technical explanation, *supra* footnote 6, states that a "Canadian resident would be precluded from claiming selected benefits under the Convention (e.g., the tax rates only) and other benefits under U.S. domestic law (e.g., the source rules only) with respect to royalties."

⁴⁴ This fact is irrelevant to the application of the domestic tax benefit provision because it refers only to benefits provided by the country applying the treaty "in the determination of the tax imposed by that state."

Inconsistent Treatment of the Same Item of Income

Case 6

USCo, a corporation resident in the United States, carries on business in Canada through a permanent establishment. During a particular year, USCo earns income of \$1,000 from the business. USCo also carries on two other businesses in Canada but does not have a permanent establishment in Canada in respect of either business. In the year in question, USCo has income of \$5,000 and a loss of \$1,000 from these two businesses. USCo reports no profit or loss for Canadian tax purposes. The profit from the business without any permanent establishment is exempt from Canadian tax under article VII of the treaty, and the loss from the other business offsets the profit from the business with a permanent establishment under paragraph 3(d) of the Act.

This is a classic case of cherry picking. USCo is attempting to apply the provisions of the Act and the treaty inconsistently to the same type of income. If USCo's Canadian tax liability is determined under the Act without applying the treaty, the income and loss from all three businesses will be taken into account and USCo will have income of \$5,000. If, on the other hand, the treaty is applied, only the income from the business with a permanent establishment is taxable in Canada. Although the treaty does not provide expressly that USCo is not entitled to any relief with respect to its loss, that proposition seems to be implicit. If Canada is not entitled to tax the profits of a business carried on in Canada unless there is a permanent establishment, it should not be required to give relief for a business loss unless there is a permanent establishment.⁴⁵ However, article XXIX(1) expressly requires Canada to give USCo relief for the business loss because it is available under the provisions of the Act without regard to the treaty. If USCo carried on only two businesses in Canada—one through a permanent establishment that produced profits of \$1,000 and the other without a permanent establishment that produced a loss of \$1,000—the domestic tax benefit provision would allow USCo to use the loss to offset its Canadian business profits. In this situation, there is no inconsistency between the Act and the treaty; USCo's Canadian tax liability is determined under the Act, ignoring the treaty. What is offensive about case 6 is the use of the Act for the business loss and the use of the treaty for the business profits.

The technical explanation states that article XXIX(1) “does not . . . authorize a taxpayer to make inconsistent choices between rules of the Code and rules of the Convention.”⁴⁶ Case 6 is a clear example of a taxpayer's making such an inconsistent choice.⁴⁷ According to the ALI study:

⁴⁵ This is the position of the IRS. See Rev. rul. 84-17, 1984-1 CB 308.

⁴⁶ The technical explanation, *supra* footnote 5, would be considered to be part of the context of the treaty under article 31(2) of the Vienna Convention on the Law of Treaties, *supra* footnote 12. As such, it would likely have a significant influence on the interpretation of article XXIX(1).

⁴⁷ In Rev. rul. 84-17, *supra* footnote 45, the IRS ruled on the same facts that a taxpayer was not entitled to treat the business profit and loss inconsistently.

In the case of business income, the statute and the treaty each sets forth a self-contained and internally consistent set of rules governing the taxation at source of business income, and these differ in important respects. The purpose of either set of rules may be carried out without allowing the taxpayer to select individual provisions most favorable to it.⁴⁸

This line of reasoning is perhaps too broad. The comment of the ALI study that business income is subject to “a self-contained and internally consistent set of rules” under the Act and the treaty assumes that all business income derived by a taxpayer is aggregated for purposes of taxation. Under the Act, however, each business is a separate source of income and the income or loss of each business is computed separately. Even the treaty recognizes different treatment for business profits that are attributable to a permanent establishment and those that are not. Therefore, if a taxpayer carries on two unrelated businesses, it is unclear why the taxpayer should not be entitled to apply the rules of the Act to one business and the rules of the treaty to the other business. For example, if the income from one business is exempt under the Act and the income from another business is exempt under the treaty, the taxpayer is not being inconsistent to claim both exemptions.⁴⁹ Although the treaty permits Canada to tax the income from the first business, Canada has decided not to do so. There is no connection between the statutory exemption for this business and the exemption from Canadian tax for another business under a treaty.

A similar analysis applies to other types of income. It seems clear that, at least in some situations, a taxpayer should be able to treat different items from the same category of income inconsistently under the Act and the treaty. Consider, for example, the following case.

Case 7

X, a resident of the United States, receives dividends in the year from a Canadian mutual fund corporation that are treated as capital gains dividends under subsection 131(1) of the Act. These dividends are exempt from withholding tax under subsection 212(2). X also receives ordinary taxable dividends from Canadian corporations in the year. These dividends are subject to the 25 percent withholding tax under subsection 212(2); however, under article X(2) of the treaty, the rate of withholding tax is reduced to 15 percent. The capital gains dividends are included in the definition of dividends in article X(3) despite being treated as capital gains for Canadian tax purposes. X claims exemption under the Act for the capital gains dividends and the reduced rate of withholding under the treaty for the ordinary dividends.

⁴⁸ ALI study, *supra* footnote 9, at 85-86.

⁴⁹ It is difficult to construct a realistic example because the only business profits exempt under the Act are prospectors' shares (paragraph 81(1)(l)) and international shipping and aircraft income (paragraph 81(1)(c)). The latter income is also exempt under Canadian treaties.

In this case, the taxpayer's use of the Act for one type of dividend and the treaty for another is not inconsistent. The treaty gives Canada the right to tax all dividends up to a maximum rate; in the case of capital gains dividends, however, Canada has decided not to tax.⁵⁰ Therefore, there is no inconsistency in permitting a taxpayer to claim the reduced treaty rate of withholding on ordinary dividends and a statutory exemption for other dividends.⁵¹

As indicated earlier, the offensive aspect of case 6 is the inconsistent treatment of the profits and the loss. It should not matter, in my view, whether the profits and losses are derived from the same activity as categorized by the treaty. For example, consider case 6 if one of the other businesses carried on by USCo in Canada is a cross-border trucking business in respect of which USCo has a permanent establishment in Canada. The profit from this business is exempt under article VIII of the treaty. Should the taxpayer be entitled, by virtue of the domestic tax benefit provision, to claim the treaty exemption for the profits from the trucking business and deduct the loss from the other business without any permanent establishment under the Act? This is a difficult question. The fact that transportation is dealt with in a separate article of the treaty seems to be too formalistic to justify the inconsistent treatment of the profits and loss. It should not matter whether the exemption for cross-border trucking is contained in article VII or article VIII. Similarly, the conclusion in case 9 below is that the treatment of business profits under article VII and the rate of branch profits tax under article X(6) should not be analyzed separately, even though they are contained in separate treaty provisions. Therefore, the only possible justification for allowing the taxpayer to make inconsistent choices between the Act and the treaty with respect to this variation of case 6 must be based on the different treatment of a cross-border trucking business and a business without any permanent establishment. The scheme of taxation for cross-border trucking businesses under article VIII prohibits the country of source from taxing the profits even if the non-resident has a permanent establishment there; the country of residence is given the exclusive right to tax. In contrast, the country of source is entitled to tax business profits of a non-resident under article VII, but only if the non-resident has a minimum presence in the country. It can be argued that the two sources of income are subject to separate regimes, so that it is not inconsistent for the taxpayer to select the treaty for one source and the Act for the other.⁵² However, this rationale is not very satisfying. It seems to be based on an assumption that all business income constitutes one source under the treaty and that the tax regime provided by article VII will be frustrated unless article VII applies to all the business income. However, it can equally be argued that where each

⁵⁰ This is the crucial difference between cases 6 and 7.

⁵¹ Similar examples could be constructed involving interest and royalties.

⁵² It would make no difference if there were a loss in the trucking business.

business is separate and unrelated, it is not inconsistent for the taxpayer to select the treaty for one business and the Act for the other.

In summary, in my view it is difficult to discern any principled rationale for restricting a taxpayer's right to choose between the treaty and the Act under the domestic tax benefit provision to all of the income governed by a particular treaty article. On the one hand, it seems too generous to allow the taxpayer to have the choice with respect to each item of income; on the other hand, it seems too restrictive to require the taxpayer to make the choice for all income. The compromise position is to require the consistent treatment of items of income of the same type, although the types of categories of income for this purpose might be determined in various ways.

Although there are no Canadian cases dealing directly with the domestic tax benefit rule in any Canadian tax treaties, there are two cases in which the Federal Court of Appeal considered the meaning of article XIII A(2) of the 1942 Canada-US treaty and subsection 216(5) of the Act. Article XIII A(2) provided as follows:

Rentals from real property derived from sources within Canada by an individual or corporation resident in the United States of America shall receive tax treatment by Canada not less favourable than that accorded under Section 99, The Income Tax Act, as in effect on the date on which this Article goes into effect.

Section 99 of the Act was the predecessor to section 216, which entitles a non-resident to elect to pay tax on real property rental income on a net basis under part I of the Act rather than on a gross withholding tax basis under part XIII of the Act. In effect, article XIII A(2) was a specific domestic tax benefit provision applicable to real property rentals.

The predecessor to subsection 216(5) was added to the Act in 1955 after article XIII A(2) became effective. Subsection 216(5) provides that if a non-resident elects to pay tax under part I of the Act and deducts any capital cost allowance, the non-resident must also pay tax under part I in any subsequent year in which the property is disposed of if there is any recapture of capital cost allowance.

In *MNR v. Bessemer Trust Co. et al.*,⁵³ the US taxpayer elected to pay part I tax on real property rent from Canada from 1965 through 1969. In 1969, it disposed of the property. The taxpayer took the position that article XIII A(2) of the treaty relieved it of the obligation of paying tax on the recapture of capital cost allowance. The minister argued that recapture of capital cost allowance was not rental income from real property and therefore article XIII A(2) had no application.

In a strange judgment, the Federal Court of Appeal found that article XIII A(2) precluded the application of subsection 216(5) of the Act because that provision provided less favourable tax treatment than existed

⁵³ 73 DTC 5045; [1973] CTC 12 (FCA).

under its predecessor, section 99, at the time that article XIII A(2) became effective. Implicit in this finding is the assumption that recapture of capital cost allowance constitutes real property rental income for the purposes of the treaty. Nevertheless, the court concluded that because the taxpayer elected in 1969 to be taxed on a net basis under part I of the Act, the recapture from the disposition of the property in that year was subject to tax. Although the court did not enunciate this position explicitly, in effect it held that the taxpayer elected to have the provisions of the Act apply rather than the provisions of the treaty despite the fact that the provisions of the treaty were more favourable.

In *The Queen v. Arnos et al. (Trustees)*,⁵⁴ the Federal Court of Appeal confirmed that recapture of capital cost allowance had the same character as rental income from real property. The court agreed with the reasoning in the *Bessemer Trust* case and held that, since the non-resident taxpayers did not make any election under section 216 at any time, article XIII A(2) of the treaty overrode subsection 216(5).

These cases suggest that where a non-resident elects to be taxed as a resident of Canada in a particular year under part I of the Act, the taxpayer could not have the benefit of an inconsistent relieving provision of the treaty. It is unfortunate that the court did not deal with the domestic tax benefit provision, and it is difficult to know how consideration of that provision would have affected the court's decision. The question left unresolved by these cases is, what would the result be in a case if the non-resident taxpayer elected under section 216 with respect to one year but did not make the election in the year in which the property was disposed of? In other words, is the taxpayer's entitlement to elect to be treated under the Act as a resident of Canada an annual choice, in which case the taxpayer could take the benefit of article XIII A(2) of the treaty in the year of disposition? The issue of temporal inconsistency between the provisions of the Act and the provisions of the treaty is discussed below.

Inconsistent Treatment of Different Items of Income

Case 8

USCo, a corporation resident in the United States, carries on two businesses in Canada. Only one business is carried on through a permanent establishment in Canada. USCo derives profits of \$1,000 from the business with the permanent establishment and a loss of \$1,000 from the other business. USCo also receives a dividend from a Canadian corporation in the year. USCo claims a deduction for the business loss against its business profits under paragraph 3(d) of the Act. It also claims entitlement to the reduced rate of withholding tax on the dividend under article X(2) of the treaty.

USCo is inconsistent in using the Act to deduct the business loss and the treaty to reduce the rate of Canadian withholding tax on dividends.

⁵⁴ 82 DTC 6165; [1982] CTC 186 (FCA).

However, this inconsistency does not frustrate the policy of either the Act or the treaty. The treatment of business income and the treatment of dividends are quite separate issues under both the Act and the treaty.

It is, however, impossible to generalize. As with the inconsistent treatment of the same item of income, it may be inappropriate in certain circumstances to permit the inconsistent treatment of different items of income. Consider, for example, the following case.

Case 9

USCo, a corporation resident in the United States, carries on two businesses in Canada. USCo derives a profit of \$10,000 from the business carried on in Canada through a permanent establishment and a loss of \$3,000 from the other business in respect of which there is no permanent establishment. USCo claims a deduction for the business loss against its business profits under paragraph 3(d) of the Act and also claims the reduced rate of Canadian branch tax on its net branch income of \$7,000 under article X(6) of the treaty.

If the Act applied without any reference to the treaty, any business losses would offset business profits and the rate of branch profits tax would be the statutory rate of 25 percent. As discussed earlier in connection with case 6, under the treaty the business loss is not taken into account because there is no permanent establishment in Canada. The reduced rate of branch tax under article X(6) applies only to the business profits attributable to the taxpayer's permanent establishments in Canada. Therefore, it would be inappropriately inconsistent for USCo to deduct its business losses for purposes of tax under part I of the Act and then to claim the reduced rate of branch tax under the treaty. Although the treatment of business profits and branch tax are dealt with in separate articles of the treaty, they are functionally interrelated and should not be dealt with separately for purposes of the domestic tax benefit provision. In this case, the taxpayer should be required to choose between

- part I tax on the business profits attributable to the permanent establishment without taking the loss into account and the reduced rate of branch tax on the profit from that business (the treaty option); and
- part I tax on the net profit from the two businesses and the statutory rate of branch tax on that net profit (the statutory option).

The taxpayer should not be able to deduct the loss under part I of the Act and to claim the reduced rate of branch tax under the treaty on the net profit from the two businesses.⁵⁵ This inconsistency between the tax base and the tax rate is explored further below.

⁵⁵ Similar examples involving the branch tax can be envisaged because of the differences between the statutory rules and the treaty rules. Article XII(6) of the treaty provides an unlimited carryforward for losses attributable to a permanent establishment and an exemption for the first Cdn.\$500,000 of branch profits. Subsection 219(1) of the Act provides (The footnote is continued on the next page.)

Temporal Inconsistency

Case 10

USCo, a corporation resident in the United States, carries on business in Canada. In years 1 and 2, USCo does not have a permanent establishment in Canada. It earns a profit in year 1 of \$100 and a loss in year 2 of \$150. In year 3, USCo does have a permanent establishment in Canada and earns a profit of \$100 that is attributable to the permanent establishment. In year 1, USCo claims exemption from Canadian tax under article VII of the treaty on the basis that it does not have any permanent establishment in Canada. In year 2, USCo does not need to claim any treaty protection, since it has a loss from its business carried on in Canada. In year 3, USCo claims a loss carryforward of \$100 in computing its taxable income under paragraph 111(1)(a) of the Act.

The question raised by this case is whether the domestic tax benefit rule operates on an annual basis. In other words, is a taxpayer required to be consistent in choosing between the Act and the treaty from year to year, or only within a particular taxation year? The technical explanation of the Canada-US treaty is silent on this point. Revenue rulings issued by the IRS seem to suggest that the rule operates on an annual basis, although the issue is not confronted directly in these rulings.⁵⁶ The ALI study, however, concludes that where the computation of taxable income from a particular source is based on a period of more than one year, the taxpayer should be required to use the same rules for the computation in all of the years in the period. Although there is no authority for the ALI's view, it does seem reasonable.

On the facts of case 10, USCo should be required to carry the loss in year 2 back to year 1 to offset the profit of that year or to ignore the profit and loss for years 1 and 2. The former is the more favourable option, under which only \$50 would remain to be carried forward to year 3 to offset the profit of that year.

Case 11

USCo, a corporation resident in the United States, carries on two businesses in Canada. In year 1, USCo earns a profit of \$1,000 from the business carried on in Canada through a permanent establishment in Canada and incurs a loss of \$1,000 in its other business, which is not carried on through a permanent establishment in Canada. In year 2, USCo has no profit or loss with respect to the business carried on through the permanent establishment, but it has a profit of \$1,000 with respect to the other business. In year 1, USCo claims a deduction for its business loss against

⁵⁵ Continued . . .

the standard three-year carryforward for losses and no exemption. Cherry picking should not be permitted in these examples. I am indebted to Joel Maslove for the point about the loss carryover.

⁵⁶ Rev. rul. 84-17, *supra* footnote 45, and Rev. rul. 80-147, *supra* footnote 31. The *Bessemer Trust* case arguably supports this position.

its business profit, with the result that there is no tax payable in Canada. In year 2, USCo claims the protection of article VII of the treaty with respect to its business profits so that, once again, there is no Canadian tax payable.

The difference between this case and case 10 is that in this case there is no loss carryover. The income from each year can be computed without regard to events occurring in the other year. Should the taxpayer be required to choose between the Act and the treaty consistently from year to year in such a case? If consistency is not required, the result will be different from the result that would occur, under either the Act or the treaty, if all the events occurred in one year. If the treaty applied and all the events occurred in one year, income of \$1,000 would be taxable in Canada as business profits attributable to a permanent establishment in Canada. On the other hand, if the Act applied and all the events occurred in one year, USCo would have business profits of \$1,000 taxable in Canada.⁵⁷ Although a consistency requirement seems reasonable in these circumstances, there is no explicit basis for it. Moreover, it is still unclear whether there is any general requirement of consistency in computing income under the provisions of the Act in the absence of express wording to that effect.⁵⁸ On this issue, the ALI study concludes that “on balance it seems preferable to limit any annual consistency requirement to situations in which the computation of tax on particular items of income involves a multi-year period.”⁵⁹ The ALI was concerned about identifying the circumstances in which a consistency requirement would be appropriate. It was concerned about situations where there was a significant change in the nature of the business or in the ownership of the business. Nevertheless, a consistency requirement does seem appropriate where the same source of income is involved in both years, as in this case. Any special circumstances could presumably be taken into account on a case-by-case basis. It must be recognized, however, that this approach makes the taxpayer’s choice between the Act and the treaty a one-time choice.

Inconsistent Treatment of Tax Base and Tax Rate

Case 12

USCo, a corporation resident in the United States, licenses Canco, a corporation resident in Canada, to use certain intangible property in Canada and the rest of the world other than the United States. USCo charges Canco a royalty of \$1,000 for the use of the intangible property; half of the royalty is attributable to the use of the property in Canada. Under paragraph 212(1)(d) of the Act, only the part of the royalty paid by Canco to USCo for the use of the intangible property in Canada is subject to

⁵⁷ ALI study, *supra* footnote 9, at 91.

⁵⁸ See B.J. Arnold, *Timing and Income Taxation: The Principles of Income Measurement for Tax Purposes*, Canadian Tax Paper no. 71 (Toronto: Canadian Tax Foundation, 1983), 38-41.

⁵⁹ ALI study, *supra* footnote 9, at 91.

Canadian withholding tax; the remainder of the royalty is not subject to Canadian tax. Under article XII(6) of the treaty, the entire royalty is deemed to have its source in Canada.⁶⁰ Accordingly, under article XII(2), Canada is entitled to tax the entire royalty, but the tax is limited to 10 percent of the gross royalty.

USCo claims that the Canadian withholding tax is limited to 10 percent of \$500 (\$50). In effect, this position is based on a combination of the tax base determined under the Act and the tax rate determined under the treaty. If the Act applies and the treaty is disregarded, the Canadian withholding tax is \$125, or 25 percent of \$500, the Canadian source royalty under the Act. Under article XII(2) of the treaty, the Canadian tax is limited to \$100, or 10 percent of \$1,000, the Canadian source royalty under the treaty.

It seems inappropriate in this case to allow the taxpayer to choose the tax base under the Act and the tax rate under the treaty.⁶¹ The rate and the base are inextricably connected in this situation.⁶² Therefore, if the taxpayer elects under the domestic tax benefit provision to take advantage of the more favourable Canadian source rule with respect to royalties, the taxpayer should be required to accept the statutory rate on the royalties. Article XII(2) of the treaty serves as an overall limitation on the amount of Canadian tax on royalties, which is dependent on both the tax base and the tax rate. Apparently, this is the position taken by the IRS. On the other hand, it may be argued that the proper interpretation of article XII(2) is to limit Canadian tax to 10 percent of the royalties that are considered to have their source in Canada under the treaty and that are actually taxed by Canada under the Act.

The issue is further complicated by the foreign tax credit implications. The purpose of articles XII(6) and XXIV(3)(a) of the treaty is to require the United States, as the country of residence, to give credit for the Canadian tax on the royalties levied in accordance with the treaty. If Canada imposes withholding tax of \$100, will the United States give credit for the entire amount or only for \$50? The United States—and Canada in the converse situation—may take the position that the additional \$50 of Canadian tax paid is not tax paid in accordance with the treaty; in effect, it is tax paid to Canada voluntarily and is therefore not a creditable tax.⁶³

⁶⁰ Under the third protocol to the treaty, article XII(6) is amended to make the source of a royalty the place of residence of the payer of the royalty. As a result, the source rule for purposes of the treaty is different from the source rule for purposes of both Canadian and US domestic law. These differences raise the possibility of cherry picking.

⁶¹ The technical explanation of the 1995 protocol amending article XII suggests that this type of cherry picking is unacceptable. See *supra* footnote 43.

⁶² See also case 9 involving the branch tax where the rate and base are similarly connected.

⁶³ See above, case 5. For a detailed analysis of the problem of the inconsistent application of a treaty by the country of residence and source, see Avery Jones et al., *supra* (The footnote is continued on the next page.)

Case 13

Canco, a corporation resident in Canada, pays interest to USCo, a corporation resident in the United States, in respect of two arm's-length debt obligations. One debt obligation has a term exceeding five years so that the interest is exempt from Canadian withholding tax pursuant to subparagraph 212(1)(b)(vii) of the Act; interest on the other obligation is subject to Canadian withholding tax. Canco withholds tax at the rate of 10 percent only on the latter loan. In this case, it seems appropriate for the interest on each obligation to be treated separately rather than on an aggregate basis, although article XI of the treaty is ambiguous in this regard.

This case is essentially the same as case 12 involving royalties, supposing that separate royalty agreements had been entered into for the Canadian market and the rest of the world. If that were the case, the exemption for royalties paid in respect of the use of property outside Canada would be the same as the exemption for interest on long-term debt. The preferable interpretation is that articles XI and XII apply on an obligation-by-obligation and a property-by-property basis, respectively. This still leaves open the question whether in case 12 the taxpayer could have achieved a different result by entering into separate agreements with respect to the use of the property in and outside Canada. The intangible property is infinitely divisible on the basis of its use in particular geographical locations, but whether property can be divided in this way for purposes of article XII is unclear.

Case 14

X, an individual, is resident in both Canada and the United States for income tax purposes. Under the tie-breaker rule in the treaty, X is deemed to be resident in the United States for purposes of the treaty. X receives interest from Canada of \$100 and incurs expenses of \$90 in earning the interest. If X were a resident of Canada, only \$10 of income would be taxable at a rate of approximately 50 percent. If the treaty applied, X would pay Canadian tax of \$10, or 10 percent of the gross interest payment. X claims that Canadian tax payable is limited to \$1, or 10 percent of the net interest income.

X's position is clearly inappropriate. Article XI(2) of the treaty indicates that Canadian tax is limited to 10 percent of the "gross amount" of the interest. Even if article XI(2) did not so provide, it is clear in this case that the tax base and the tax rate constitute a package. The taxpayer should be entitled, pursuant to the domestic tax benefit provision, to choose to pay tax as a resident under the Act on net interest income at the applicable statutory rate, or as a non-resident under the treaty on the

⁶³ Continued . . .

footnote 17, at 48-54; ALI study, *supra* footnote 9, at 61; and Klaus Vogel and Rainer G. Prokisch, "General Report," in *Interpretation of Double Taxation Conventions*, *supra* footnote 7, 55-85, at 76-79.

gross interest at the reduced treaty rate. But the taxpayer cannot be permitted to select the tax base from the Act and the tax rate from the treaty.

This case is different from the royalty example (case 12). In this case, the treaty operates as a limitation on the amount of domestic tax imposed. For example, if Canadian tax on the net interest income at progressive rates exceeds \$10, the taxpayer will choose non-resident status under the treaty and thereby limit the Canadian tax to \$10. Case 12, on the other hand, involves a situation where domestic tax is not imposed despite the absence of any limitation on domestic tax under the treaty.

Status Issues

Case 15

X, an individual, is a resident of both the United States and Canada for income tax purposes. Under article IV(2) of the treaty, X is deemed to be a resident of the United States for purposes of the treaty. X owns all of the shares of a US corporation, which derives foreign accrual property income (FAPI) during the year. X also receives rental income from the use of property in Canada during the year. X does not carry on business in Canada or have any permanent establishment in Canada during the year. X claims that he is a resident of the United States under the treaty, and therefore any FAPI is taxable only by the United States pursuant to article XXII(1) of the treaty. On the other hand, X claims that the domestic tax benefit provision permits him to deduct the expenses incurred in earning the rental income as a resident of Canada, rather than pay tax on a gross withholding basis under paragraph 212(1)(d) of the Act as a non-resident.

The question raised by this case is whether the domestic tax benefit provision allows a taxpayer to take inconsistent positions with respect to his status for tax purposes. The US position on this issue is that consistency is required.⁶⁴ A taxpayer can choose to be a resident of the United States or the treaty country pursuant to the tie-breaker rule, but must do so consistently for all items of income covered by the treaty. This approach seems reasonable if both the Act and the treaty operate on the assumption that a taxpayer has a consistent status for all purposes.

With respect to the residence status of a corporation, subsection 250(5) of the Act provides that a corporation is deemed to be a non-resident if it is considered to be resident in another country for purposes of the treaty with that country. Subsection 250(5) was intended to deal with the insertion of dual-resident holding corporations between a Canadian corporation and its US parent corporation for the purpose of avoiding Canadian withholding tax on dividends.⁶⁵ The holding company was incorporated in the

⁶⁴ Internal Revenue Code, proposed reg. section 301.7701(b)-7(a). See the ALI study, *supra* footnote 9, at 89.

⁶⁵ See, generally, Robert F. Lindsay, "Canadian Subsidiaries and Nonresident Parent Corporations: Selected Tax Issues," in *Report of Proceedings of the Thirty-Seventh Tax* (The footnote is continued on the next page.)

United States, with its management and control in Canada. For purposes of the Act, the company was considered to be a resident of Canada. As a result, dividends paid by the Canadian corporation to the holding company were not subject to Canadian withholding tax and the holding company was entitled to deduct the dividend under subsection 112(1) as an intercorporate dividend. For purposes of the treaty, the holding company was considered to be resident in the United States. As a result, dividends paid by the holding company to the US parent company were also not subject to Canadian withholding tax by virtue of article X(5) of the treaty.

It is generally thought that subsection 250(5) requires corporations to have a single status—resident in Canada or non-resident—for all purposes. It precludes situations where a corporation is resident in the treaty country for the purposes of the treaty but is resident in Canada for all other purposes. However, the relationship between subsection 250(5) and the domestic tax benefit provision raises some doubt concerning the accuracy of this conclusion. The domestic tax benefit provision arguably entitles a dual-resident corporation to choose to be treated as a resident of Canada rather than take the relief from Canadian tax afforded by non-resident status under the treaty. Therefore, it seems that a corporation that is resident in Canada under Canadian law but resident in the treaty country for purposes of the treaty still has a choice as to resident or non-resident status. If the corporation elects to be taxed as a resident of Canada without regard to the treaty, it is difficult to see how subsection 250(5) alters this result, since it is dependent on the application of the treaty.⁶⁶ Nevertheless, it does seem clear that a corporation should be consistent with respect to its status as a resident under the Act or as a non-resident under the provisions of a treaty. Subsection 250(5) prevents a corporation from cherry picking between resident status under the Act and non-resident status under a treaty.⁶⁷

⁶⁵ Continued . . .

Conference, 1985 Conference Report (Toronto: Canadian Tax Foundation, 1986), 21:1-28, at 21:14-16; and Derek T. Dalsin, "Canada-U.S. Dual Resident Corporation: Tax Planning Restricted," *International Tax Planning* feature (1986), vol. 34, no. 3 *Canadian Tax Journal* 621-30.

⁶⁶ A similar problem does not arise with respect to regulation 5907(11.2), which deems a foreign affiliate to be resident in a country only if it is resident there for purposes of the treaty between Canada and the country. Ordinarily, a foreign affiliate is not resident in Canada and therefore is not entitled to claim the benefits of resident status. If the foreign affiliate is a dual resident but the tie-breaker rule in the treaty makes the affiliate resident in the other country, subsection 250(5) applies, subject perhaps to the corporation's choosing to be a resident of Canada pursuant to the domestic tax benefit rule.

⁶⁷ The same issue could arise with respect to contributions to a registered pension plan or registered retirement savings plan. Contributions under these plans are limited to a percentage of a taxpayer's "compensation" and "earned income," respectively. Under subsections 147.1(1) and 146(1), the definitions of "compensation" and "earned income" include a non-resident's Canadian source employment and business income unless the income is exempt by treaty. A taxpayer should not be entitled to use the domestic tax

(The footnote is continued on the next page.)

The other issue with respect to a corporation is whether its status as a resident or non-resident must be chosen consistently from year to year or whether the status can be elected annually. As discussed earlier, there is nothing in the domestic tax benefit provision to suggest that the choice of status under the Act or the treaty is a one-time choice. Status issues do not generally require temporal consistency in the way that the treatment of loss carryovers does. Therefore, unless there is some good reason to require temporal consistency, the taxpayer should be entitled to choose status under the Act or the treaty on an annual basis.

With respect to individuals, there is no counterpart to subsection 250(5). Therefore, an individual may be treated as a non-resident for purposes of the treaty and as a resident of Canada for all other purposes. In addition, the domestic tax benefit provision appears to allow the taxpayer to choose to be a resident of Canada despite the effect of the tie-breaker rule in the treaty. As discussed earlier in connection with source rules, although resident status is an indirect way of obtaining tax benefits, the wording of the domestic tax benefit provision seems to accommodate this interpretation.⁶⁸ Moreover, to exclude status questions from the application of the domestic tax benefit provision would not be consistent with the underlying purpose of the rule, which is to codify the principle that tax treaties are exclusively relieving. Where a taxpayer would pay less Canadian tax as a resident of Canada than as a non-resident, the taxpayer should be entitled to choose the status that results in the lesser amount of tax. Therefore, in case 15, X should be entitled to pay tax on the net rental income derived from Canada under part I of the Act rather than pay withholding tax under part XIII on a gross basis.

If it is agreed that the domestic tax benefit provision should extend to status issues, the next question is whether the provision entitles the taxpayer to make inconsistent choices with respect to status. If in case 15 X chooses to pay tax as a resident of Canada on the rental income, should X also be treated as a resident of Canada for purposes of the FAPI rules? If there is a consistency requirement, should it be limited to situations in which the same source of income is involved? In case 15, the two sources of income are totally unrelated. Although there is merit to the ALI's argument that "[t]he determination of status is a matter which controls the entire pattern of taxing rules applicable to an individual,"⁶⁹ in fact, the combination of the Act and a treaty may produce one status for purposes of the treaty and another for all other purposes under the Act. Moreover, there is no provision with respect to individuals similar to subsection

⁶⁷ Continued . . .

benefit provision to claim non-resident status with respect to his Canadian source employment and business income, but resident status for his contributions to a registered pension plan or a registered retirement savings plan.

⁶⁸ See above, under the heading "Source Rules."

⁶⁹ ALI study, *supra* footnote 9, at 89.

250(5) with respect to corporations to indicate that an individual must have a single status for tax purposes. This is a very difficult issue. Although it seems likely that Revenue Canada would be reluctant to allow the taxpayer to make inconsistent choices with respect to status, it is not at all clear how Canadian courts would resolve the issue.

Two other important but ancillary issues arise with respect to status issues under the domestic tax benefit provision. First, can one taxpayer's choice of status pursuant to the domestic tax benefit provision affect the tax consequences to other taxpayers? For example, in case 15, if X chooses to be treated as a resident of the United States pursuant to the tie-breaker rule in the treaty, X will not be subject to Canadian tax in respect of any FAPI of controlled foreign affiliates. Is the US corporation in which X owns shares a controlled foreign affiliate in respect of other Canadian resident shareholders?⁷⁰ The answer here seems clear that the tie-breaker rule applies only for purposes of the treaty and only for the purpose of relieving the tax burden for the taxpayer claiming the benefit of the treaty. For all other purposes, including the status of the US corporation as a controlled foreign affiliate, X is a resident of Canada.

The issue is more difficult with respect to corporations because of subsection 250(5). If a corporation is resident in the treaty country for purposes of the treaty, it is deemed to be a non-resident of Canada for purposes of the Act generally. Therefore, the corporation's status as a non-resident may affect other taxpayers. However, if the corporation is entitled to choose to be treated as a resident of Canada pursuant to the domestic tax benefit provision, it is unclear whether the tax consequences to other taxpayers should be affected. On the one hand, the corporation would be considered to be a resident of Canada if the treaty were ignored, and this status might affect other taxpayers. On the other hand, subsection 250(5) makes the result under the treaty applicable for purposes of the Act generally. If the corporation chooses pursuant to the domestic tax benefit provision not to have the treaty apply, perhaps the corporation's choice should apply only for the purpose of relieving its tax burden.

Second, because the domestic tax benefit provision operates with respect to both treaty countries, there is the possibility that a taxpayer might make inconsistent choices as between the two countries, even though the taxpayer selects a consistent status for each country. For example, assume that a taxpayer who is resident in both Canada and the United States is considered to be resident in the United States pursuant to the tie-breaker rule in the treaty. Assume further that the taxpayer chooses to be treated as a resident of Canada for tax purposes pursuant to the domestic

⁷⁰ Assume, for example, that X owns 45 percent of the shares and Y owns 15 percent of the shares. If X and Y are both residents of Canada, the corporation is controlled by a group of five or fewer Canadian residents. On the other hand, if Y is a resident and X is a non-resident, the corporation is not controlled by Canadian residents and will not be a controlled foreign affiliate of Y unless X and Y are related.

tax benefit provision. For US tax purposes, the taxpayer will be treated as a resident of the United States under both the Code and the treaty. Although the dual-resident status of the taxpayer is contrary to the basic purpose of the tie-breaker rule in the treaty, which is designed to establish a taxpayer's residence in only one of the two countries, it flows directly from the taxpayer's choice under the domestic tax benefit provision. Presumably, taxpayers will opt for this dual-resident status only where it is favourable.

Case 16

X, an individual, is a Canadian citizen living in Washington, DC, where he is employed by the government of Canada. X is not resident in Canada. X receives interest from Canada during the year.

X is considered to be a resident of Canada for purposes of the treaty by virtue of article IV(5). In addition, X is taxable only in Canada on his employment income by virtue of article XIX. X claims that he is a non-resident of Canada for purposes of the Act so that he is not taxable in Canada on his employment income. However, X claims the benefit of the treaty as a resident of Canada and, as a result, claims that the interest is taxable under part I of the Act on a net basis rather than under part XIII on a gross withholding tax basis.

In this situation, the domestic tax benefit provision permits X to choose whether to pay tax in the United States as a resident of that country or to pay tax only in Canada as a result of the treaty. If, however, the taxpayer chooses to be treated as a non-resident in order to avoid paying Canadian tax on his employment income, he should be treated as a non-resident of Canada for all purposes. The policy of article IV(5) is clearly that a taxpayer's status must be determined for the purpose of the treaty as a whole. In the absence of article IV(5), the issue would be more difficult to resolve, but even here the more reasonable result is to require the taxpayer to be consistent with respect to his residence status.

The taxpayer's US tax situation also raises interesting issues. If X claims to be a resident of the United States for Canadian tax purposes, is X entitled to claim status as a resident of Canada under the treaty for US tax purposes? The taxpayer's position is obviously inconsistent between the two countries and results in no tax payable in either country, an outcome that violates one of the fundamental purposes of tax treaties. However, the taxpayer is not taking inconsistent positions with respect to each country considered separately, and this inconsistency seems to be the primary focus of the domestic tax benefit provision. Moreover, it is unclear in this situation which country's tax claim should prevail. Under the treaty, Canada has the exclusive right to tax. But if the taxpayer chooses not to have the treaty apply, the United States should have the right to tax. Ensuring that at least one country taxes the income in this situation assumes a high level of cooperation between the tax authorities of the two countries.

CONCLUSION

I realize that this is one of those disappointing articles that raise more questions than they answer. The domestic tax benefit rule is a real sleeper. The analysis in this article attempts to demonstrate that the implications of the rule deserve more serious consideration by tax advisers and by the Canadian government. The Canadian treaty negotiators should analyze in detail the possible implications of a domestic tax benefit provision and re-evaluate the inclusion of the provision as a standard feature of Canadian tax treaties. From the analysis in this article, it seems to me that, subject to one significant caveat, the domestic tax benefit provision should cease to be a standard feature of Canadian tax treaties or its meaning should be clarified. The caveat relates to the basic principle that tax treaties are relieving in nature. If the same results would be reached under that basic principle as under the domestic tax benefit provision, of course the presence or absence of the provision in the treaties is of little consequence. Whether or not this is the case is unclear. However, it does not seem likely to me that Canadian courts would reach precisely the same results under the general principle as they would under the specific wording of the domestic tax benefit provision.

If the domestic tax benefit provision is to be retained, its meaning should be clarified. This clarification could take the form of a technical explanation of the treaty or an administrative interpretation issued by Revenue Canada. In any event, the clarification should be in accordance with the following principles. These principles are drawn in large part from the principles set out in the ALI study,⁷¹ here elaborated on and

⁷¹ ALI study, *supra* footnote 9, at 92-93:

Recommendations:

Article 1, paragraph 2, of the U.S. Model Treaty and similar provisions involving the interaction of Code and treaty rules should be interpreted in the following manner:

(a) A taxpayer electing to claim treaty benefits with respect to any item of income must treat all income derived during the taxable year in the same treaty category as provided in the treaty. To the extent that the treaty permits the imposition of a tax which is not imposed under internal law, the internal law exemption continues to apply.

(b) A taxpayer claiming statutory treatment with respect to one category of income may nevertheless claim treaty benefits with respect to another category of income derived in the same taxable year when the relation between the treaty provisions and the Code rules is such that they can be applied independently without distorting the application of either system to the items of income involved.

(c) A taxpayer electing to be treated as a resident of one of the treaty countries for a taxable year pursuant to a treaty "tie-breaker" provision will be treated for that year as a non-resident of the other treaty country with respect to all items of income covered by the treaty. This election can be made on an annual basis.

(d) When the application of any provision of statutory law takes into account tax attributes of a multi-year period (e.g., net operating loss carry-over, a foreign tax credit carry-over, or income averaging), either statutory rules or treaty rules

(The footnote is continued on the next page.)

adapted to the Canadian situation. The principles are advanced tentatively, with the expectation and hope that subsequent commentators will take the analysis in this article to a higher level and revise the principles accordingly.

1) In general, the domestic tax benefit provision permits a taxpayer to be taxed under the provisions of the Income Tax Act without regard to the otherwise applicable provisions of a tax treaty.

2) A taxpayer should be required to indicate in the tax return for the year that he is choosing to apply the Act rather than the treaty. This designation should decrease the possibility of taxpayers' making inconsistent choices between the Act and the treaty that are undetected.

3) A taxpayer should not be entitled to apply the provisions of the Act and the treaty to duplicate tax benefits that are intended to be alternatives.

4) If a taxpayer claims relief for foreign taxes on an item of income under the treaty or the Act, the taxpayer should be required to apply the corresponding source rules under the treaty or the Act. Otherwise, the limitation on the foreign tax credit will be overstated.

5) The domestic tax benefit provision should not allow a taxpayer to choose to pay more tax to a foreign country than is exigible in accordance with the treaty.

6) A taxpayer should be entitled to claim an exemption under the treaty for one item of income and an exemption under domestic law for another item of income, even items of the same category of income.

7) A taxpayer should not be entitled to choose the treaty for one item of income and the domestic law for another item of the same category. Conversely, a taxpayer should be entitled to choose the treaty for one item of income and the domestic law for another item of income of a different category. A "category" of income for this purpose could be defined in a variety of ways: for example, in accordance with the categories established in the treaty or those established in the domestic legislation.

8) A taxpayer must be required to use the provisions of the treaty or the domestic legislation consistently from year to year where the computation of income from a particular source involves a period of more than one year (for example, where carryovers are involved). Consistency from year to year should also be required in other circumstances with respect to the same source of income unless a change can be justified by the taxpayer. Temporal consistency should not be required with respect to a taxpayer's status.

9) A taxpayer should not be entitled to choose the tax base determined by the treaty and the tax rate determined by domestic law, or vice versa.

⁷¹ Continued . . .

must be consistently applied to all of the tax attributes involved in the computation. The taxpayer can change his election from year to year, but such a change requires a full recomputation of all amounts relevant for all of the periods involved.

10) A dual-resident corporation should not be entitled to avoid the effects of subsection 250(5) by electing to be a resident of Canada by virtue of the domestic tax benefit provision. This result could probably be accomplished by an amendment to the Income Tax Conventions Interpretation Act.

11) A dual-resident individual should not be entitled to elect to be a non-resident of Canada under the treaty for some purposes and a resident of Canada under the domestic tax benefit provision for other purposes. A taxpayer should not be required to choose resident or non-resident status under the treaty or domestic law consistently from year to year. Only a taxpayer's status determined under domestic law should be relevant for other taxpayers.