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NOT JUST FOR AMERICANS: THE CASE FOR EXPANDING RECIPROCAL TAX EXEMPTIONS FOR FOREIGN INVESTMENTS BY PENSION FUNDS*†

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SUMMARY

From provision of OAS, GIS and CPP to the favourable taxation of Registered Pension Plans and RRSPs , Canada's government has long focused policy efforts on better ensuring that working Canadians approach retirement with sufficient income supports in place. If the government wants to continue to move in this direction by trying to help maximize returns to pension plan members, while decreasing the portfolio risks faced by those pension plans, one step it could consider would be: Expanding the exemption for withholding taxes on foreign dividends and interest earned by pension plans.

The exemptions for foreign interest and dividends are already available to U.S. investments, part of a reciprocal arrangement spelled out in the Canada-U.S. Tax Convention. Those exemptions allow U.S. and Canadian pension funds to participate in cross-border investments that would otherwise be too costly.

Pension funds rely on international investments to optimize diversification and returns. And tax conventions between countries are typically designed to protect investors from the participating countries from being double taxed by both their resident country and the foreign jurisdiction where they invest. This good policy has certainly been Canada's model in its numerous bilateral tax treaties.

But while the U.S.-Canada Tax Convention extends the benefit of tax exemption to dividends and interest earned from cross-border investments by tax-exempt pension funds, when it comes to all other countries, there is no equivalent result. Yet, aspects of these same exemptions exist in certain bilateral treaties between other countries in treaties with one another. That certainly suggests that there are other trading partners, besides just the U.S., that are open to the possibility of these particular exemptions.

If Canada could negotiate broadening these exemptions to countries beyond the United States, it would realize important advantages with little cost. By not moving further in this direction for non-U.S. foreign interest and dividend income of Canadian pension funds, these funds are left with lower benefits or higher contribution rates for pension plan members. It is also inevitably distorting the investment decisions being made by pension fund managers, producing a negative impact on risk-adjusted returns to their portfolios. While Canada may lose some revenue by forsaking some withholding tax, that would almost certainly be outweighed by the total economic gains as pension returns increase and, in reciprocal arrangements, Canada becomes more welcoming to foreign capital.

With a number of countries already evidently open to the idea of tax exemptions for foreign interest and dividends earned by pension funds, and the economic effects for doing so overwhelmingly positive, the Canadian government should seriously consider getting started on negotiating reciprocal arrangements for cross-border pension fund investment with other countries.

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POURQUOI SE LIMITER AUX ÉTATS-UNIS? PLAIDOYER EN FAVEUR DE L'ÉLARGISSEMENT DES EXONÉRATIONS FISCALES RÉCIPROQUES POUR LES INVESTISSEMENTS ÉTRANGERS DE FONDS DE PENSION[*†]

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RÉSUMÉ

Des dispositions du SV, du SRG et du RPC aux taux d'imposition favorables des régimes de pension agréés et des REER, le gouvernement du Canada a longtemps concentré ses efforts sur l'amélioration de politiques garantissant aux travailleurs canadiens un soutien au revenu suffisant à l'approche de la retraite. Pour continuer à oeuvrer dans cette voie — en s'efforçant de maximiser le rendement pour les membres des régimes de retraite, tout en diminuant les risques du portefeuille auxquels ces régimes sont exposés —, le gouvernement pourrait envisager d'étendre l'exonération pour retenue d'impôt sur les dividendes et les intérêts étrangers tirés des régimes de pension.

Les investissements américains bénéficient déjà d'exonérations pour les intérêts et les dividendes étrangers, dans le cadre d'un accord de réciprocité intégré à la Convention fiscale Canada-États Unis. Ces exonérations permettent aux fonds de pension américains et canadiens de participer à des investissements transfrontaliers autrement trop coûteux.

Les fonds de pension dépendent d'investissements internationaux pour optimiser leur diversification et leurs rendements. En outre, les conventions fiscales entre pays sont généralement conçues de manière à protéger les investisseurs des pays participants contre une double imposition (par leur pays de résidence et par le pays étranger où ils investissent). Le Canada a d'ailleurs appliqué cette politique avisée à ses nombreuses conventions fiscales bilatérales.

La Convention fiscale Canada-États Unis, qui étend l'exonération fiscale aux dividendes et aux intérêts d'investissements transfrontaliers tirés de fonds de pension exonérés d'impôt, n'a pas d'équivalent ailleurs. Certains éléments de ces exonérations figurent néanmoins dans les traités bilatéraux d'autres pays, ce qui laisse entendre que des partenaires commerciaux du Canada (autres que les États Unis) pourraient être intéressés par ces exonérations.

Le Canada pourrait obtenir des avantages importants à peu de frais s'il négociait l'élargissement de ces exonérations pour les revenus d'intérêts et de dividendes étrangers non américains des fonds de pension canadiens; faute de quoi, il priverait les prestataires de régime de pension d'une hausse des prestations ou d'une baisse des taux de cotisation. Cela fausserait inévitablement la prise de décisions de placement des gestionnaires de fonds de pension et, ce faisant, nuirait à la rentabilité ajustée à des valeurs de risque de leurs portefeuilles. Il se peut que le Canada perde une partie de ses recettes en renonçant à certaines retenues d'impôt, mais cette perte serait presque certainement compensée par les gains économiques totaux résultant de l'augmentation des rendements des fonds de pension et d'accords de réciprocité attirant des capitaux étrangers au pays.

Sachant, d'une part, qu'un certain nombre de pays sont déjà manifestement ouverts à l'idée d'exonérations fiscales pour les dividendes et les intérêts étrangers tirés de fonds de pension et, d'autre part, que les effets économiques de l'élargissement de ces exonérations sont extrêmement avantageux, le gouvernement canadien devrait sérieusement envisager de négocier des accords de réciprocité avec d'autres pays touchant les investissements transfrontaliers de fonds de pension.

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A. INTRODUCTION

This paper reviews the income tax treatment of Canadian pension funds, which are generally exempted from taxation under the federal Income Tax Act (the "ITA") and similar provincial legislation, with respect to certain investments that the funds may make in other countries. Under the current Canada-U.S. Tax Convention, both countries have agreed to exempt certain items of income paid to tax-exempt pension funds resident in the other country from withholding tax so long as the pension plan is not related to the resident payer. Because these pension funds are not taxable in their home jurisdiction, and thus cannot receive any tax credit for foreign tax paid, this has enabled Canadian and U.S. pension funds to participate in cross-border investments that would otherwise be too costly for them.

While Canada and the United States have agreed to this exemption, Canada has not adopted a similar exemption for tax-exempt pension funds with other countries. Yet the United States has provided some exemptions for other countries, and some of our major trading partners, such as the United Kingdom and Japan, have also provided certain exemptions for foreign-tax-exempt pension funds. We argue that there is a strong economic case, based on economic efficiency, that Canada would be able to diversify investment markets better by arranging with countries other than the United States for reciprocal exemption of certain income paid to non-resident tax-exempt pension funds. It will also facilitate more foreign pension funding of Canadian investments including infrastructure.

Our discussion proceeds as follows. We first provide some background information on the role of pension funds in cross-border investments. This is followed by a discussion of general policy considerations for tax treatment of international investment flows, and the current Canadian tax policy and tax treatment of such flows, including discussion of economic distortions related to such flows. We then examine the special tax treatment of tax-exempt pension funds provided for under Article XXI of the Canada-U.S. Tax Convention with respect to income earned on certain cross-border investments made by them, and some related circumstances. We conclude with an analysis of the extent to which it would be beneficial, from a public policy perspective, to seek the implementation of Article XXI-type or similar tax treatment with respect to Canadian pension fund investment in other countries, and foreign pension fund investment in Canada.

B. CROSS-BORDER INVESTMENT BY PENSION FUNDS

Pension funds are important institutional investors, holding US$21.8 trillion in assets in 2012 among OECD countries, over three times the amount in 1995 (Figure 1). The pension funds share of overall pension-related assets was 67.9 per cent, followed by bank and investment companies (18.5 per cent), insurance companies (12.8 per cent), and employee back reserve (0.8 per cent).[1]

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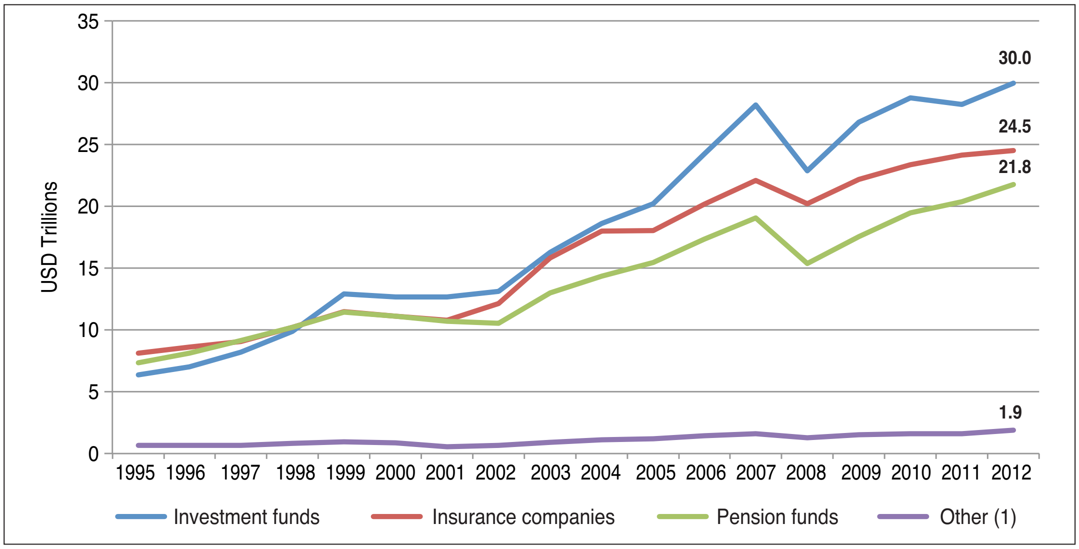
[1] OECD, *Pension Markets* in Focus (Paris: OECD, 2013), 8.

FIGURE 1: TOTAL ASSETS BY TYPE OF INSTITUTION FOR OECD COUNTRIES 1995-2012



Source: OECD Global Pension Statistics, various years.

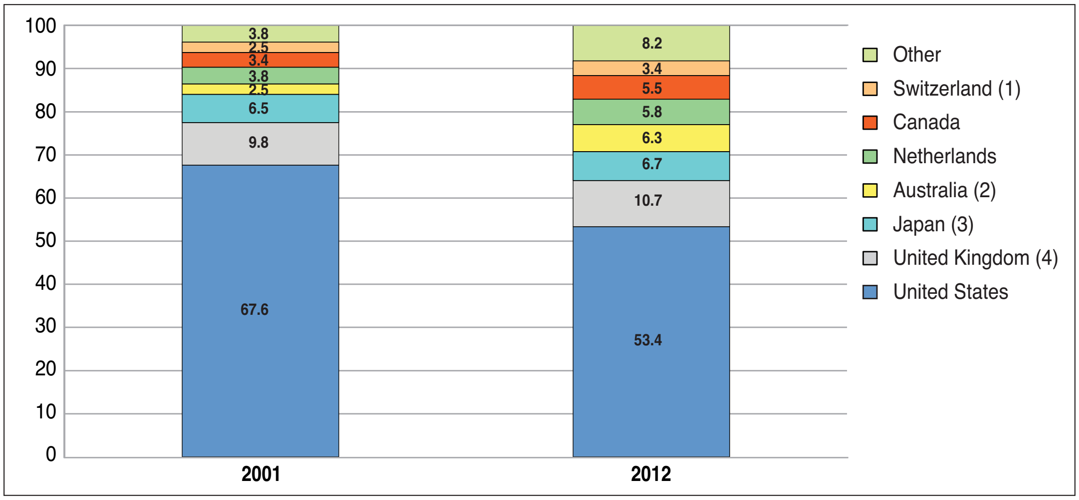
Note:

1. *Other forms of institutional saving include foundations and endowment funds, non-pension fund money managed by banks, private investments, partnerships, and other form of institutional investors.*

In 2012, the countries accounting for the largest share of OECD pension fund assets include the United States (53.4 per cent), the United Kingdom (10.7 per cent), Japan (6.7 per cent), Australia (6.3 per cent), the Netherlands (5.8 per cent) and Canada (5.5 per cent), as shown in Figure 2.

Pension funds invest in other foreign countries, especially those in the U.S., Japan, Luxembourg, the Netherlands, Switzerland, Canada and the United Kingdom. As shown in Figure 3, Canadian pension funds invested 31.5 per cent of their assets in foreign jurisdictions.

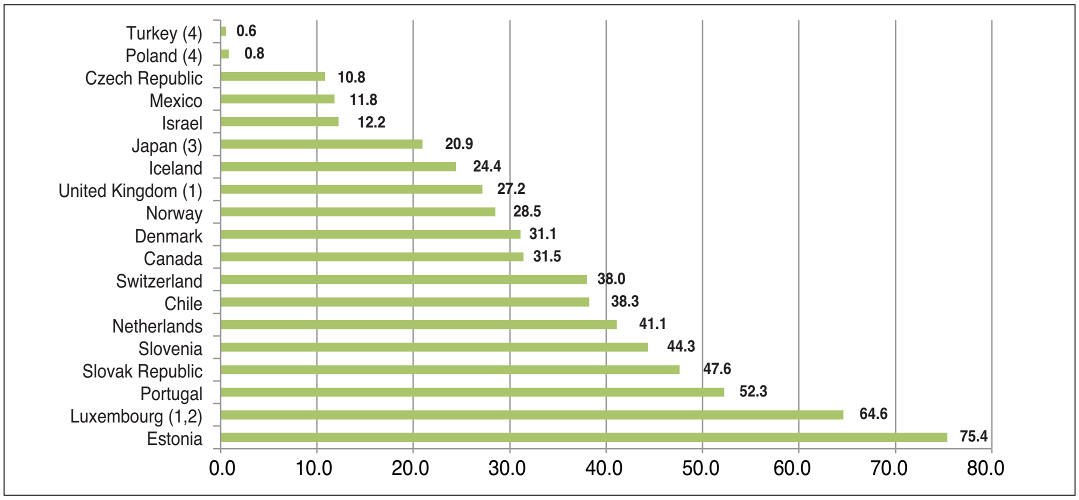
FIGURE 2: GEOGRAPHICAL DISTRIBUTION OF PENSION FUND ASSETS (OECD) 2001 AND 2012



Source: OECD Global Pension Statistics, various years.

Notes:
1. *Data refer to the first trend calculation for the year 2012.*
2. *Data refer to the end of June of each year.*
3. *Bank of Japan.*
4. *The figure for total assets at the end of 2012 is an early estimate based on the 2011 level of assets and the flow of transaction in 2012. It does not take in to account value changes.*

FIGURE 3: FOREIGN INVESTMENT OF PENSION FUNDS IN SELECTED OECD COUNTRIES IN 2012



Source: OECD, Pension Markets in Focus (Paris: OECD, 2013).

Notes:
1. *Data refer to 2011 only.*
2. *Data refer to funds under the supervision of the CSSF only.*
3. *Data from Bank of Japan.*
4. *Data refer to personal pension funds only.*

However, pension fund cross-border investments tend to be placed more in equity securities rather than debt. Overall, Australian, Canadian, Japanese, Dutch, Swiss, U.K. and U.S. pension funds have reduced holdings of domestic securities from 64.7 per cent of equity assets in 1998 to 46.5 per cent in 2012.[2] Canadian pension funds hold less than 40 per cent of their equity assets in domestic securities as of 2012, the least among six countries reviewed by Towers Watson. On the other hand, 82.5 per cent of bond assets held by pension funds are domestic securities, with Canadian pension funds holding over 90 per cent of their bond assets in domestic securities.

C. TAXATION BACKGROUND

In a world of large and increasing international capital flows, overlapping rights to taxation of income by more than one country pose numerous difficulties. Given that a capital-importing jurisdiction has the right to tax income earned by non-residents at source and a capital-exporting jurisdiction has the right to tax worldwide income earned by residents, double taxation can arise with respect to cross-border investments.

Generally, in order to obtain some measure of *capital-export neutrality*, countries levying income taxes seek to tax the business and investment income earned by their residents from foreign sources at a similar rate as they tax income from domestic sources. To achieve capital-export neutrality at the global level, the source country would exempt from tax any income

[2] Towers Watson, *Global Pension Assets Study 2013* (January 2013), http://www.towerswatson.com/en/Insights/IC-Types/Survey-Research-Results/2013/01/Global-Pensions-Asset-Study-2013.

earned by non-residents who instead pay tax to their country of residence or, alternatively, the country of residence would provide a credit for foreign income taxes and withholding taxes paid by residents as an offset to its own taxes on foreign source income earned by residents (as further explained below). For full capital-export neutrality, a capital-exporting country would refund the excess foreign tax paid by resident investors abroad when foreign taxes are more than its tax on such income.

At the same time, many countries, in order to obtain some measure of *capital-import neutrality*, also seek to tax the business and investment income earned directly by non-residents that has a source in their jurisdiction in the same way they tax such income earned by their own residents. The exemption of foreign source income by capital-exporting countries achieves capital-import neutrality in foreign jurisdictions for taxpayers resident in the capital-exporting country.

The objectives of capital-export neutrality and capital-import neutrality are not compatible (unless, improbably, all countries have the same rate of income tax and the same tax base so that the tax credit and exemption systems are the same in effect). Instead, countries are left to pursue “second-best” policies that often involve a mix of these approaches.

Many countries typically combine (i) income taxation of residents on a worldwide basis with (ii) taxation of income from a business carried on in that jurisdiction by a non-resident and taxation on a gross withholding basis of payments of investment income, such as dividends, interest, rents and royalties, made by a resident to a non-resident. Where a resident of one country that applies this approach derives business or investment income from another country that also applies this approach, the taxation by the two countries overlaps and results in inconsistent and potentially onerous treatment.

For income of a resident of one country that is derived from carrying on a business in another country, this often takes the form where both the source country and the residence country, at first instance, levy full income taxes on such income. For income in the form of receipt of items such as dividends, interest, rents or royalties, this usually takes the form of the residence country levying full income tax on receipts by its resident, and the source country levying a gross withholding tax on the amount of the payments by its resident. The source country may also, in addition to full taxation in the residence country, levy tax on capital gains of the resident of the other country on certain of the underlying property.

The circumstances thus described could obviously effect a double taxation of the same income (in the two different jurisdictions), which can be inefficient economically, inequitable to the earner of the income and injurious to the competitiveness of enterprises of the residence jurisdiction. Accordingly, countries often judge it to be in their best interests to adopt an international tax policy approach that will go some way toward sorting out and ameliorating such double taxation. This can be done: (i) unilaterally (that is, voluntarily) by one country, usually the country of residence of the earner of the income, through the provision of tax exemptions, credits or deductions with respect to the foreign source income, or by the source country not taxing this income; (ii) bilaterally through use of a binding agreement — in the form of a tax convention or treaty between the two countries involved — that allocates taxation rights and reduces or eliminates double taxation, usually by providing some limits on the rights of the source country to tax and by requiring the residence country to provide an exemption or tax credit for remaining source country taxation; or (iii) by some combination of unilateral and bilateral provisions.

The potential problems that could arise more specifically from overlapping international tax jurisdiction with respect to international capital flows in the form of income such as dividends, interest, rents and royalties (and taxation of capital gains on the underlying property) have been greatly ameliorated by the existence of hundreds of bilateral income tax conventions that have been negotiated and put in force by many countries, largely patterned on the *Model Tax Convention on Income and on Capital* developed and maintained by the OECD (the "OECD Model Convention").[3] Canada, for instance, has entered into bilateral income tax conventions with 92 other countries around the world,[4] generally patterned on the OECD Model Convention. In very general terms, the approach of the OECD Model Convention, in order to allocate taxation rights and deal with potential double taxation on cross-border business and investment, is as follows:

- Where a resident of one of the countries carries on business directly in the other country (not including active business income of locally resident companies) the income from that business can be taxed by the residence country, but not by the source country except to the extent the business is carried on through a permanent establishment in the source country.
- Where a resident of one of the countries receives from the other country certain items of income, such as dividends, interest, rents and royalties (or recognizes capital gains on underlying property) not connected with the carrying on of a business in the source country, at first instance the country of source is still allowed to levy a tax on this income; but this tax is subject to any tax rate limits set out in a particular tax convention. These tax rate limits can run from total prohibition of such taxation (seen with payments of interest in certain circumstances) to no prohibition on such taxation (sometimes seen with certain rents or royalties). The country of source also usually accepts a limitation on its ability to tax capital gains of non-residents on underlying property owned by the non-resident that is located in the jurisdiction, but preserves its right to tax capital gains on certain such property, often including real property or resource property. The mere investment in equity or debt securities of a corporation resident in the source country will not usually, by itself, constitute such carrying on of a business by the recipient.
- The country of residence of the person carrying on business in the other country or receiving these items of income from the other country is then allowed to bring the income into account for taxation. But it is required to provide relief from double taxation in the form of an exemption of the income from tax or a tax credit for the tax paid on the item of income up to the amount of the tax it levies on the income. Such a tax credit is insufficient to provide effective relief from double taxation — and can be particularly unfair and inefficient — where the source country has levied its tax on a gross withholding basis (that is, without deduction of costs laid out to earn the income) and the residence country credits tax only to the extent of the amount of net income (that is, after deduction of such costs).
- The country of residence is also expected to provide some relief by exemption or tax credit against the tax it levies on capital gains of its resident that have been permitted to be taxed in the source country.
- The OECD Model Convention does not contain any special provisions dealing with income earned by organizations that are exempt from income tax in their country of residence, such as tax-exempt pension funds or charities.

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[3] See the OECD Model Tax Convention on Income and on Capital 2010 (Paris: OECD, 2010).

[4] Canada, Department of Finance, "Notice of Tax Treaty Developments," http://www.fin.gc.ca/treaties-conventions/treatystatus_-eng.asp.

Canada generally levies income taxes on the worldwide income of residents, and on the income of non-residents from employment or carrying on business in Canada, from capital gains on certain Canadian-sited property and, on a gross withholding tax basis, from payments to them by residents such as dividends, interest, rents and royalties. As part of its income tax system, Canada maintains a large network of bilateral tax conventions,[5] which include those made with countries with major economies such as the U.S., the U.K., Japan, EU member countries, as well as with Russia, China and Brazil. Each of these Canadian tax conventions has been negotiated and amended separately over a lengthy period of time so that, when dealing with any particular investment situation, it is most important to refer to the exact text of the relevant convention. Nevertheless, a review of Canadian bilateral income tax conventions does indicate a general Canadian approach to the tax treatment of cross-border income flows in applicable circumstances along the following lines:

- Preservation of the right of Canada and the other country, as source countries, to fully tax income from the carrying on of a business in the jurisdiction through a permanent establishment or fixed base there under the usual income tax provisions, including income from dividends, interest, rents and royalties that are connected to such a business.[6]
- Preservation of the right of Canada and the other country, as source countries, to tax dividends, interest rents and royalties that are paid by its resident to a resident of the other — though, usually the tax rate allowed to be levied in such a case, most often levied as a gross withholding tax, is limited by the tax convention in the following manner:
  - 5 per cent tax rate limit on dividends for a corporation controlling directly or indirectly at least 10 per cent of the voting power in the payer, and 15 per cent tax rate limit on other dividends;
  - 10 per cent tax rate limit on interest on debt; though some income tax convention provisions, such as the current Article XI of the Canada-U.S. Tax Convention,[7] which prevents the levying of any tax on such interest —effectively establishing a zero tax rate limit — provide various broad source country tax exemptions for interest;[8]
  - 10 per cent tax rate limit on royalties, except for royalties related to cultural works, computer software, patents and know-how, which may be taxed only at a lower rate or are exempt.[9]

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[5] Currently, Canada has over 90 bilateral tax conventions in force, with a number of others under negotiation.

[6] Canada, like some other countries, also taxes on a current basis the passive investment income of controlled foreign corporations of its residents (through the Foreign Accrual Property Income rules in the ITA).

[7] See note 21 below.

[8] Other Canadian income tax conventions that provide for various exemptions from source country taxation on interest include, for example: the Canada-Switzerland Tax Convention (1997), as amended, which provides for exemption from tax in the source country of most interest paid to a resident of the other country that is not related to the payer — see Article 11, paragraph (3)(c); and The Canada-Hong Kong Tax Convention (2012) which provides a similar source country tax exemption for arm's length interest, in Article 11, paragraph (3)(e). Also, some Canadian conventions, such as the Canada-New Zealand Tax Convention (2012), provide an exemption from source country taxation for most interest received by residence country financial institutions that are not related to the payer — see Article 11, paragraph (4).

[9] Canada levies a 25 per cent withholding tax on rents and royalties paid to non-residents, subject to limitations provided for in its bilateral income tax conventions. Such limitations, as set out above, normally do not apply where this income is earned through a permanent establishment or fixed base in Canada.

- Restriction on Canada and the other country, as source countries, on taxing capital gains on property sited in the country other than, generally, real property and resource property.
- Preservation of the right of Canada and the other country to tax the worldwide income of its residents, subject only to specific limits in a convention.
- Requirement for Canada and the other country, as residence countries, to provide certain relief to reduce or eliminate double taxation resulting from the authority that is left to the source country to tax certain items of income, even if within limits.

Most Canadian tax conventions do not contain special provisions that prevent or limit taxation of items of income earned specifically by a pension fund or other organization exempt from tax in Canada or the other country; however, in addition to the important pension fund tax exemption provisions of Article XXI of the Canada-U.S. Tax Convention, to be discussed in Section E below, some other Canadian income tax conventions do contain special provisions that exempt from taxation interest received by a pension fund that is exempt from income tax in Canada or the other country, as a resident thereof, that is not received in the course of carrying on a business in the source country or from a related party.[10]

In summary, Canadian income tax conventions generally favour low or no non-resident withholding taxes (except with respect to certain rents and royalties), significant restriction on the type of property that is subject to capital gains taxation of non-residents, and reduction of remaining double taxation by exemption or tax credit in the country of residence.

D. ECONOMIC DISTORTIONS AND TAXES ON CROSS-BORDER FLOWS OF INCOME

The Canadian approach to bilateral income tax conventions tends toward application of the principle of capital-export neutrality for outbound portfolio investment made by Canadian residents in foreign countries (equivalent taxation of foreign and domestic investments),[11] but only limited application of the principle of capital-import neutrality for portfolio investment in Canada by non-residents (allowing potentially lower taxation of non-resident investors relative to domestic investors).[12]

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[10] See, for example the Canada-Namibia Tax Convention (2010), Article 11, paragraph (3)(e), the text of which is set out in Appendix 3; the Canada-Luxembourg Tax Convention (1999),as amended, Article 11, paragraph (3)(c); and the Canada-Austria Tax Convention (1976), as amended, Article XI(7)(e). It is worth adding, however, that these countries may not necessarily currently levy broad source-based taxes on interest paid to non-residents; in such a case, the tax-convention exemption still serves as protection for Canadian pension funds against future imposition of broader source-based taxation.

[11] With respect to direct outbound investment, the Canadian tax system generally provides an exemption for dividends remitted from active business income of qualifying foreign affiliates in treaty jurisdictions. This is consistent with capital-export neutrality to the extent that such income is already taxed by foreign governments at comparable rates, but in practice has tended instead to provide a large measure of capital-import neutrality to Canadian direct outbound investors in the foreign jurisdictions.

[12] For example, under Part XIII of the ITA, withholding tax of 25 per cent is levied on payments of dividends, some interest, and rents and royalties paid by Canadian residents to non-residents, and this tax is often limited or reduced by the overriding provisions in Canadian bilateral income tax conventions.

This is good public policy because, while it can result in some reduction in Canadian income tax revenues from non-resident investors, this is more than balanced by the benefits of greater economic efficiency,[13] fairness and competitiveness that are achieved with respect to international investment involving Canadians. Because of the importance of this issue, some deeper explanation will be provided here of economic benefits and costs associated with cross-border taxation of investment flows, and of the implications for improvements in taxation of these flows.[14]

The typical justification for the imposition of taxes on international income flows is based on revenue grounds. The so-called *treasury-transfer effect* applies to cases where the home country of foreign residents investing in Canada uses the foreign tax credit approach to eliminate the double taxation of international income, as is the case in the U.S. To the extent that Canadian income and withholding taxes are fully credited against the domestic taxes of foreign investors, these taxes are simply a transfer of revenue from the foreign treasury to the Canadian treasury. In this case, there are no investment-incentive effects, and Canadian taxes on cross-border investments are essentially a lump sum, non-distortionary tax. The treasury-transfer effect is sometimes used to argue for higher income and withholding taxes on non-residents investing or operating in Canada.

This argument is, however, overly simplistic as there are many situations in which it does not apply. The most obvious is when the home country of the non-resident investor does not follow the foreign tax credit approach to eliminating double taxation, but rather follows the exemption method whereby the country exempts foreign source income earned by its residents from tax and no credit is given for withholding taxes.

Countries sometimes differentiate their income tax treatment of foreign source income of their residents based on whether the income is earned directly or indirectly through a foreign resident affiliated corporation that repatriates the income through dividends paid to the resident. With regard to income earned indirectly through foreign affiliated corporations, of the major capital-exporting countries today, only the U.S. uses the foreign tax credit approach for underlying foreign taxes on affiliate dividends paid to a U.S. recipient; the others, including Canada, largely follow the exemption approach for dividends paid from affiliates operating in foreign jurisdictions.[15] Moreover, and importantly, the U.S. uses a global approach to taxing foreign source income whereby qualifying income from different sources is aggregated and the

[13] We define economic efficiency in typical economic terms: allocating resources in the economy according to their best use. In markets, price signals indicate to consumers and producers how to best allocate resources. If taxes distort prices, then resources may not be put to their most optimal use (leaving aside special considerations when markets fail to achieve the best allocation of resources requiring some form of government intervention in the economy such as regulation, taxes or subsidies).

[14] For background see, for example, the discussion of efficiency gains and losses associated with withholding tax reductions in the Canadian economy in J. Mintz, "Withholding Taxes on Income Paid to Non-Residents: Removing a Canadian-U.S. Border Irritant," Backgrounder (Toronto: C. D. Howe Institute, 2001).

[15] The U.K. and Japan recently converted to the exemption method for qualifying dividends. Note that, in the case of dividends paid to individuals or in the case of corporations with small ownership levels in foreign companies, the dividends are taxed as income and withholding taxes are credited.

foreign tax credit is based on the aggregate amount of foreign taxes paid.[16] Due to the ability to cross-credit, and limitations on the extent to which corporations can claim the foreign tax credit, many corporations based in the U.S. are not able to fully utilize the credits arising from income and withholding taxes since the total credits may be in excess of U.S. tax liability. In these so-called "excess credit" cases, withholding taxes are distortionary and do impinge upon investment.

With regard to foreign source income earned directly by their residents — say, in the form of dividends, interest, rents or royalties — some countries also provide exemption, but others, like Canada and the U.S., only provide tax credits for foreign tax within defined limits for foreign withholding tax paid on such income.[17] This foreign tax crediting is often insufficient to provide full elimination of double taxation. Moreover, where such cross-border income is received by tax-exempt pension funds, such as those resident in Canada, tax credit for foreign income or withholding taxes will not be made available to these investors because they already are exempt from tax.

Without full foreign tax crediting, withholding taxes are distortionary, and are not lump sum. For a small open economy, which cannot influence international interest rates, the optimal tax rate on capital imports is zero (a tax on economic rents would be appropriate).[18] There is some evidence to suggest that home bias results in some immobility of capital, thereby implying a positive tax rate on capital. However, with increased capital mobility in the past two decades, capital-importing countries have been reducing taxes on capital, especially corporate income tax rates.[19] The few studies have generally shown that withholding taxes on interest income, not credited against foreign tax liabilities, are shifted fully to the borrower in the form of higher interest expense.[20] For the capital-importing country, the loss in income earned by immobile factors of production (land and labour) swamps any gain in tax revenue.

We therefore note that the case for reduced taxes on cross-border investments is stronger when no crediting, or less than full crediting, is involved for income and withholding taxes.

[16] The current approach in the U.S. is to separate sources of income between "general category" (primarily active) and passive income baskets.

[17] J. Mintz and A. Weichenrieder, *The Indirect Side of Direct Investment* (Boston: MIT Press, 2010).

[18] Ibid. See also: K. McKenzie, *An Analysis of the Economic Effects of Withholding Taxes on Cross-Border Income Flows for Canada* (Research Report Prepared for the Advisory Panel on Canada's System of International Taxation, 2008).

[19] See: Mintz and Weichenrieder, *The Indirect*, chapter 6.

[20] See: H. Huizinga, "The incidence of withholding taxes: evidence from the LDC loan market," *Journal of Public Economics* 59, 3 (1996) 435-451. One older Canadian study has shown that the Canadian withholding tax on bond interest paid to non-residents tends to be shifted forward in higher interest costs charged to Canadian borrowers (D. Brean, "International Portfolio Capital: The Wedge of the Withholding Tax," *National Tax Journal* 37, 2 (1984) 239-248).

E. THE CANADA-U.S. TAX CONVENTION AND TAX-EXEMPT PENSION FUNDS

The policy of increasing capital-export neutrality for non-active business investments made directly by Canadian residents, as described above, could be seen as being broadened by a bilateral income tax convention to the extent that it provides for residents of Canada that are exempted from income tax domestically, say because of their status as a charity or a pension fund, to be granted partial or full exemption from income tax in another country in which they make investments. While provisions of such a convention could obtain this result relatively easily, Article XXI of the Canada-U.S. Tax Convention[21] appears to be the only provision of this type to be found in a Canadian income tax convention that deals with exemption for both dividends and interest.[22] However, it should be borne in mind that pension funds, or other organizations that are legally considered as agents of the Government of Canada or of a province, may still be exempt from tax in other countries with respect to investment income derived there, as Canada and a number of other countries recognize reciprocal foreign sovereign immunity to taxation as a completely separate matter.[23]

The text of Article XXI (Exempt Organizations), which together with the rest of the Convention generally has the force of law in both countries, is set out in detail in Appendix 1.[24] The key provision of the Article, for purposes of the taxation of non-resident pension funds, is paragraph 2. It states that dividend or interest income referred to in Articles X and XI of the Convention, respectively, derived in one of the countries by a resident of the other country that is a trust, company, organization or arrangement that is generally exempt from income tax in that country of residence, and that is operated exclusively to administer or provide pension, retirement or employee benefits, shall be exempt from tax in the country where it is derived. This tax exemption also extends to a legal vehicle, such as a trust or company, that is exempt from tax in the country of residence and is operated to earn income for the benefit of such a resident,[25] but does not apply to income that comes from carrying on a trade or business in the source country, or to income from a related person.[26] Article XXI contains different, more comprehensive tax exemption provisions relating to tax-exempt charities and other similar organizations resident in one of the countries with respect to income derived from the other.[27] As well, Article XXI contains provisions to allow certain cross-border donations to be made on a more tax-advantaged basis.[28]

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[21] Canada-United States Tax Convention (1980) as amended by protocols of 1983, 1984, 1995, 1997, and 2007.

[22] See note 10 above for examples of special pension fund exemptions for interest in Canadian bilateral income tax conventions.

[23] See Canada Revenue Agency, Information Circular 77-16R4, paragraph 50, for the terms and conditions of the application of the doctrine of sovereign immunity from taxation by Canada.

[24] While the exemption for charities and the like in this Article derives from Article X of the previous Canada-U.S. Convention (1942), there appears to be no exemption in that previous Convention similar to the exemption for pension funds now in Article XXI.

[25] See paragraph 3.

[26] See paragraph 4.

[27] See paragraph 1, and related provisions of Article XXI.

[28] See paragraphs 6 and 7.

Thus, for example, dividends received by a Canadian registered pension plan from a U.S. corporation will generally be exempt from any U.S. withholding or other tax, as will interest received from the U.S. in any case where the Convention does not otherwise prevent such tax from being levied. This exemption can be quite crucial in these circumstances because, as noted above, these tax-exempt cross-border investors are not allowed any tax credit for foreign income or withholding taxes. It is important to note here that, because the Convention now contains a separate broad prohibition on taxation of interest in the state where it arises,[29] the primary effect of Article XXI as regards tax-exempt pension funds' foreign investment, is to exempt them from withholding tax on dividends received from a resident of the other country.

The current U.S. Model Income Tax Convention[30] (the "U.S. Model Convention") does not contain a provision as potentially broad-ranging as Article XXI of the Canada-U.S. Tax Convention. However, the U.S. Model Convention does contain a provision in its Article 10[31] that provides that dividends received by a resident of one of the countries that is a tax-exempt "pension fund" from a corporation resident in the other country are exempt from tax in that source country, provided that the dividends are not derived from the carrying on of a trade or business by the pension fund or received from an associated enterprise. For this purpose, the U.S. Model Convention defines the term "pension fund" as any person established in one of the countries that is generally exempt from income taxation there, and is operated principally either i) to administer or provide pension or retirement benefits, or ii) to earn income for the benefit of one or more such persons.[32] This approach to its tax treaties by the U.S. of providing a limitation on the taxation of cross-border dividends received by tax-exempt pension funds, without any other special provisions to limit taxation of such funds, can be seen in its application in a number of U.S. tax conventions, for example the current U.S.-U.K. Income Tax Convention and U.S.-Germany Income Tax Convention.[33]

The U.S. Model Convention also contains, in Article 11, a provision for a general exemption from source country taxation of interest paid from one country to a resident of the other country that does not receive the payment in the course of carrying on business through a permanent establishment or fixed base in the source country.[34] This pattern of exemption can be seen in effect in a number of U.S. bilateral income tax conventions, including those with the U.K., Germany and France.[35]

Moreover, the provisions of Article XXI of the Canada-U.S. Tax Convention appear to have started out by effecting a broader application of tax exemption for tax-exempt pension funds than the exemption more generally accepted by the U.S. approach to its tax treaties at the time.

[29] See Article XI of the Convention.

[30] United States Model Income Tax Convention 2006 (Washington: Department of the Treasury).

[31] See paragraph 3 of Article 10 of the U.S. Model Convention, the text of which is set out in Appendix 2.

[32] See Article 3 of the U.S. Model Convention.

[33] See paragraph 3 of Article 10 of the U.S.-U.K. Income Tax Convention (2001), as amended, and paragraph 3 of Article 10 of the U.S.-Germany Income Tax Convention (1989), as amended.

[34] See paragraph 1 of Article 11 of the U.S. Model Convention.

[35] See Article 11 of the U.S.-U.K. Income Tax Convention (2001), as amended; the U.S.-Germany Income Tax Convention (1989), as amended; and the U.S.-France Income Tax Convention (1994), as amended.

But the subsequent elimination of withholding tax on interest, through both domestic tax changes and amendments to Article XI of the Convention, has left the taxation of cross-border investments by such pension funds generally in line with the basic U.S. Model Convention approach to this situation. Of course, while not relevant for current considerations, Article XXI of the Canada-U.S. Convention does also still provide a broad tax exemption for income earned in one country by charities and the like that are resident in the other country, a provision not found in the U.S. Model Convention or in other U.S. tax conventions.

There is one other, quite significant development that appears to stem from the U.S. tax treaty approach to providing for exemption from tax on cross-border dividends received by tax-exempt pension funds. That is, that this U.S. approach to dividend taxation has been adopted and utilized in some bilateral tax conventions made between two other countries where, obviously, the U.S. is not involved. An example of this is the Japan-U.K. Income Tax Convention (2006), which contains in paragraph 3(b) of Article 10 a provision very similar to that in the U.S. Model Convention (and certain U.S. tax conventions that are in force). It provides that dividends paid by a resident of one of the countries to a resident of the other country shall not be taxed in the former country if the owner of the dividend is "a pension fund or pension scheme," provided that such dividends are not derived from the carrying on of a business, directly or indirectly, by such pension fund or pension scheme. For this purpose "a pension fund or pension scheme" is defined as a plan, scheme, fund, trust or other arrangement established under the laws of the residence country, operated principally to administer or provide pensions, retirement benefits or other similar remuneration or to earn income or gains for the benefit of one or more such arrangements, and is exempt from tax in its state of residence in respect of such activities.[36]

Moreover, the use of a general exemption from source country taxation of interest paid to non-residents, along the lines reflected in the U.S. Model Convention, has not only been put into effect in a number of other U.S. bilateral tax conventions,[37] but is also in effect in a number of other bilateral tax conventions in force between other countries, such as the U.K.-Germany Income Tax Convention (2010), in Article 11. Significantly, the U.K. and Japan, even though they appear unwilling to effect such a general exemption from source country tax on interest in their bilateral tax convention, have provided a special exemption from such tax for "pension funds or pension schemes" resident in the other country.[38]

The relevance and importance of the existence of special source country tax exemption provisions for dividends and interest, such as those in Articles 10 and 11 of the Japan-U.K. Income Tax Convention, is that it directly indicates some degree of willingness of these two countries to enter into reciprocal tax treaty arrangements of this type to exempt from tax cross-border dividends and interest paid by their resident companies to a tax-exempt pension fund of another treaty partner country. This could have positive implications for changes to the current bilateral income tax convention arrangements between Canada and the U.K. and Canada and Japan. It may also suggest that other countries already are, or will eventually be, willing to make changes along these lines in their bilateral income tax conventions with Canada.

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[36] See Article 3, paragraph 1(m) of the Japan-U.K. Income Tax Convention (2006).

[37] See note 35 above.

[38] See the Japan-U.K. Income Tax Convention (2006), Article 11, paragraph 3(d).

F. POSSIBLE CHANGES IN CANADIAN BILATERAL INCOME TAX CONVENTIONS

The provisions of Article XXI of the Canada-U.S. Tax Convention, which generally exempt dividends and interest received by a tax-exempt pension fund resident in one of the countries from taxation in other country, reflects the longstanding proximity and integration of North American capital markets. However, as shown in Figure 2 above, pension funds from many countries have taken up a larger share of global assets in recent years and have increased their international equity portfolios. The fact that some other countries do now provide for tax exemption of investment flows in the form of dividends, or interest, or both, paid by their residents to foreign tax-exempt pension funds for selected treaty partners, further supports cross-border investments in global equity markets.

Canada has gone some way to providing such support for cross-border investment, by reducing taxes on dividend payments to foreign residents in bilateral tax conventions, and by providing limitations on source state taxation of interest flows to foreign residents, both in Canadian domestic taxation rules and in some of its bilateral tax conventions. In this section we will examine whether Canada should seek to broaden reciprocal tax exemption for certain cross-border income flows to pension funds to include other situations beyond the United States and the existing exemption provisions for interest referred to in Section C above.

This discussion is divided into two parts. The first part focuses on economic efficiency and related considerations as to the advisability in policy terms of broadening in this way the exemption related to cross-border flows of capital investment by tax-exempt pension funds. The second part describes a detailed approach for its bilateral income tax conventions that Canada could consider adopting, should it decide on the merits of such a broadening of exemption.

1. POLICY ARGUMENTS FOR BROADENING TAX EXEMPTION FOR CROSS-BORDER PENSION FUND INVESTMENT

An argument for broadening the tax exemption for pension fund cross-border investments can be made on the basis of the general benefits of removing barriers to the flow of inbound and outbound capital. The considerations with respect to the economic efficiency effects of removing withholding taxes on pension fund cross-border investments have some similarity to the general case discussed in Section D above. This is particularly so because, as noted above, Canadian registered pension plans receive no tax credit in Canada for foreign income and withholding taxes, as a consequence of being tax-exempt. However, some additional considerations specific to tax-exempt pension fund investment also apply.

We first note that Canada follows an approach that exempts from income taxation income earned by registered pension plans. This is consistent with the "expenditure" approach to personal taxation, whereby taxpayers saving in registered accounts deduct contributions to pension funds from their personal tax base and include withdrawals of principal and investment returns to fund their retirement. No tax is paid by the pension fund on income earned by it. The rationale for this approach to taxing pension fund income and other retirement saving is to remove the additional tax paid by savers on income derived from earnings that have already been subject to income tax. As economists have also argued over the years, the expenditure approach to taxation also ensures that savers and consumers are taxed on the same basis.[39] The tax exemption enables savers to accumulate wealth faster with higher yields (given the tax exemption) to fund their retirement consumption.

Nonetheless, it might be argued that a withholding tax exemption for pension funds and not other taxpayers distorts capital markets by providing a tax advantage for pension funds to invest in foreign assets compared to other investors. However, this same criticism has been invoked against the general tax exemption provided for retirement saving plans since investors will prefer tax-exempt rather than taxable saving instruments. For this reason, the Canadian government has provided the tax exemption for saving on a limited basis by limiting contributions to tax-exempt savings plans by reference to income, subject to an overall limit. Savings not invested in pension and other tax-exempt assets are then held in taxable accounts, which is typically the case for higher-income taxpayers who have savings in excess of contributions limits.

It therefore seems somewhat incongruous that pension funds should be subject to withholding taxes on income they receive from foreign jurisdictions. The tax, which is paid to a foreign government, reduces the income earned by the pension fund ultimately resulting in either lower benefits paid to pension holders or higher contribution rates. This view has been taken for cross-border pension investments with respect to the United States with the tax exemption for dividends and interest provided through the Canada-U.S. Tax Convention. It would be consistent with Canadian tax policy with respect to economic efficiency if this type of exemption for Canadian pension fund investment were to be broadened to investment in other countries. This would also have the desirable effect of enabling Canadian pension funds to better diversify their asset holdings across a range of other countries, which would also help maximize risk-adjusted returns on their investment portfolios.

As noted, a tax exemption for cross-border dividends and interest received by tax-exempt pension funds could, arguably, provide some advantage to pension fund investors compared to taxable investors. This distortion can offset to some degree the economic efficiency gains from reducing withholding taxes. However, the existing exemption provided for pension funds in the Canada-U.S. context creates another distortion arising from the imposition of withholding taxes on pension funds investing in the U.S. compared to those investing elsewhere outside Canada. Overall, we would expect an economic gain from reducing withholding taxes on pension fund investment involving Canadian treaty partners other than the U.S. in terms of portfolio diversification and increased investment in Canada.

While a strong case can be made in this way to broaden tax exemption for Canadian pension funds' foreign source investment income beyond existing exemptions, such as in the Canada-U.S. Tax Convention, a legitimate question arises as to whether an efficiency argument can be made to exempt foreign pension funds from Canadian withholding taxes. This question is all the more important because of the presumed need to grant reciprocal exemption from Canadian tax to the other country's tax-exempt pension funds in any bilateral Canadian income tax convention that would provide exemption from foreign tax to Canadian pension funds. One

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[39] See: D. Bradford, *Untangling the Income Tax* (Cambridge, Mass.: Harvard University Press, 1984); and James Meade (ed.) Design of the Income Tax System (London: Institute of Fiscal Studies,1978).

argument for a reciprocal withholding tax exemption for foreign pension funds investing in Canada is that it would enable Canada to attract more financing of Canadian domestic investment. Given that the exemption already exists in the Canada-U.S. context to help attract capital, a similar argument can be made for exempting pension funds from other countries from Canadian tax to increase capital inflows into Canada. As discussed above, the economic gain from additional investment would be a benefit to Canada. This results because the withholding tax on income paid to a foreign pension plan is not usually creditable in its home jurisdiction; so that Canadian firms operating in Canada's small open economy which use international sources of finance face a higher cost of financing as Canadian withholding tax is shifted onto them.[40]

Where a distinction might be made is with respect to cases in which a withholding-tax exemption invites control of a Canadian operating business by foreign pension funds. While it would benefit Canada to attract more foreign savings from pension funds, a pension fund gaining control of a company raises other economic efficiency issues related to "acquisition-for-control markets." The role of takeovers is not just to provide capital, but also to achieve managerial and technological efficiencies arising from new management. A tax exemption for pension funds could distort capital markets to the extent that some investors acquire control because of their ability to reduce or eliminate corporate taxes once the acquisition is achieved, thereby enabling them to outbid taxable investors. Thus, acquisitions could in some circumstances be based on tax considerations rather than managerial advantages,[41] thereby distorting capital markets. To deal with this issue, it would be advisable for Canada to limit any reciprocal pension fund tax exemption on dividends to not apply in circumstances of income from related persons, as is generally done for dividends in Article XXI of the Canada-U.S. Tax Convention.[42] Other issues may suggest the advisability of Canada limiting any reciprocal pension fund tax exemption on interest to not apply where interest is received from related parties, as is done in current special source country interest exemptions in Canadian tax conventions.[43]

To summarize, the efficiency arguments for exempting from withholding tax cross-border income paid to tax-exempt pension funds is predicated on the following points:

- The exemption from withholding tax for Canadian pension funds would increase Canadian incomes from foreign investments. The intent of exempting Canadian pension funds from taxation of investment income is to reduce the distortion between future consumption and current consumption that exists if such income is fully taxed.
- Given that Canadian pension funds are tax exempt on domestic income and certain investment income paid to Canada from the U.S., income derived from other jurisdictions that is subject to withholding tax distorts pension plan investment decisions and reduces diversification of portfolios and the risk-adjusted returns available to pension plan members. Broadening the tax exemption for pension funds to more countries would improve rates of return benefiting their members.

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[40] See the reference to studies mentioned in footnote 20.

[41] Jack Mintz and Vijay Jog, "Sovereign Wealth Funds and Pension Plans Controlling Canadian Businesses: Tax Policy Implications," *SPP Research Papers* 6, 5 (University of Calgary, The School of Public Policy, 2012).

[42] See section E above. The U. S. Model Convention also contains a similar limitation based on the concept of an "associated enterprise" (see the discussion above in section E), as do other U.S. tax conventions based on it.

[43] See, for example, the provisions of Article 11, paragraph 3(e), of the Canada-Namibia Tax Convention (2010) in Appendix 3.

- An exemption of foreign pension plans from Canadian withholding tax would reduce the cost of capital for Canadian businesses, ultimately leading to more business investment, since it would be expected that withholding tax is shifted onto borrowers for small open economies such as Canada.
- Limiting a withholding tax exemption to income from unrelated parties reduces any potential distortions in acquisition markets for control.

One other relevant consideration here is the potential revenue impact of broadening the current Canadian tax exemption for U.S. tax-exempt pension funds. By broadening the exemption to tax-exempt pension funds in other countries, the federal government would lose some withholding tax revenue, which we are unable to estimate.[44] However, we note that a full evaluation of revenue effects would take into account any new corporate taxes derived from increased foreign savings invested in Canada by such pension funds that are incremental to the existing capital stock. Even if there is some revenue loss to Canada, the efficiency gains should fully offset revenue losses, as in the case of the withholding tax exemption provided for arm's length interest in the 2007 federal budget. Notably, as a result of this general withholding tax exemption now in Canadian domestic tax rules, successful negotiation of new reciprocal tax exemptions in Canadian bilateral income tax conventions for interest paid to tax-exempt pension funds, from other than related parties, would cost Canada *no loss of tax revenue*.

2. DETAILED APPROACH FOR BROADENING CROSS-BORDER SOURCE COUNTRY TAX EXEMPTION FOR TAX-EXEMPT PENSION FUNDS

Because the issue under consideration here is reduction of taxation of Canadian tax-exempt pension funds in other countries, any new or broadened income tax exemption would need to be provided for by the country that is the source of the income, and thus would, in most cases, need to be accomplished by Canada negotiating changes to its bilateral tax conventions. As noted, this would almost certainly involve reciprocity on the part of Canada vis-à-vis taxation of foreign pension funds with Canadian source income.

Having said this, there are clear precedents for some form of such a source country tax exemption provision on cross-border dividends received by tax-exempt pension funds in Article XXI of the Canada-U.S. Convention, in existing U.S. bilateral tax conventions with countries such as the U.K. and Germany, and in other bilateral tax conventions such as the U.K.-Japan Tax Convention.[45] There are also clear precedents for some form of source country tax exemption provision on cross-border interest received by tax-exempt pension funds in those same conventions, and in several existing Canadian bilateral tax conventions.[46]

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[44] No data are available to measure the amount of withholding tax paid by pension funds on an unrelated-party basis for non-U.S. countries. An exemption from withholding tax provided to pension funds could reduce the cost of capital for Canadian businesses and increase corporate tax payments. Further, the reduction of the withholding tax provided by the foreign jurisdiction would increase Canadian pension payouts to the extent pension funds earn higher returns on income, thereby leading to an increase in personal income taxes. While some revenue loss would be expected, the amounts would be expected to be relatively small. For an example of the sort of calculations needed to assess the tax exemption for pension plans in the related-party context, see: V. Jog and J. Mintz, "The 30 Per cent Limitation for Pension Investment in Companies: Policy Options," *Canadian Tax Journal* 60, 3 (2012), 567-608.

[45] See references to each of these provisions in sections C and E above.

[46] See note 10 above.

It would thus seem reasonable for Canada in considering the possibility of obtaining greater source country tax exemption for its tax-exempt pension funds, with the benefit of these precedents, to focus on two separate potential improvements to existing and new bilateral Canadian tax conventions to the extent these do not deal with this issue: (1) addition of an exemption from source country tax on cross-border dividend flows received by non-resident tax-exempt pension funds, such as contained in Article XXI of the Canada-U.S. Convention; and (2) addition of an exemption from source country tax on cross-border interest flows received by non-resident tax-exempt pension funds, such as contained in Article 11 of the Canada-Namibia Tax Convention.

Therefore it would be our recommendation, based on the economic and policy analysis set out above in this paper, that Canada take the initiative to work with other important bilateral tax-convention partners with a view to amending these conventions to provide reciprocal source country exemption provisions for dividends and for interest as follows:[47]

(i) provisions would be added to provide a basic exemption from source country tax on dividends and a basic exemption from source country tax on interest received from a source in one country by a pension fund that is resident and exempt from tax in the other country;

(ii) such exemptions would also apply to vehicles owned by such a pension fund, as provided in paragraph 3 of Article XXI of the Canada-U.S. Tax Convention; and

(iii) such exemptions would not apply to dividends or interest received in connection with the carrying on of a business in the source country or received from a related party (other than from a vehicle provided for in (ii) above).

If, for various reasons, a reciprocal source country dividend exemption proves more difficult to obtain, then a reciprocal source country interest exemption for unrelated party interest would still be worth achieving as a substantial improvement for cross-border pension fund investment.

We recognize that the pursuit of such an approach by Canada would involve negotiations over a period of time, individually with a number of Canada's tax convention partners, and that there are often other negotiation dynamics in play. However, given the potential economic benefits involved, we feel it could still be useful for Canada to begin the process, sooner rather than later, of exploring the possibility of such tax-convention changes with those of its major tax convention partners that already appear to have accepted such provisions in some of their other bilateral tax conventions — in particular, the U.K. and Japan. Approaches to other partners could proceed in due course. If this approach were to be adopted, it may also be helpful for Canada to consider making it generally known if, and under what conditions, it would be prepared to negotiate such a reciprocal source country tax exemptions for tax-exempt pension funds with its tax convention partners.

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[47] The question of whether "anti-discrimination" provisions in certain existing Canadian bilateral tax conventions would be of assistance in pursuing this approach will not be discussed here.

G. CONCLUDING COMMENT

In this paper, we have considered the possible broadening of the current Canada-U.S. reciprocal source country tax exemption for cross-border dividends and interest received by tax-exempt pension funds, and the current tax exemption provisions for cross-border interest received by them in existing provisions of some other Canadian bilateral income tax conventions, to other Canadian bilateral tax convention arrangements. We have concluded, based largely on the grounds of increased economic efficiency, that within the limits discussed, this would be a sound public policy approach for Canada to pursue.

APPENDIX 1

CANADA-UNITED STATES TAX CONVENTION (1980)
AS AMENDED BY THE FIVE PROTOCOLS SIGNED FROM 1983 TO 2007

Article XXI – Exempt Organizations

1. Subject to the provisions of paragraph 4, income derived by a religious, scientific, literary, educational or charitable organization shall be exempt from tax in a Contracting State if it is resident in the other Contracting State, but only to the extent that such income is exempt from tax in that other State.

2. Subject to the provisions of paragraph 4, income referred to in Articles X (Dividends) and XI (Interest) derived by a trust, company, organization or other arrangement that is a resident of a Contracting State, generally exempt from income taxation in a taxable year in that State and operated exclusively to administer or provide pension, retirement or employee benefits shall be exempt from income taxation in that taxable year in the other Contracting State.

3. Subject to the provisions of paragraph 4, income referred to in Articles X (Dividends) and XI (Interest) derived by a trust, company, organization or other arrangement that is a resident of a Contracting State, generally exempt from income taxation in a taxable year in that State and operated exclusively to earn income for the benefit of one or more of the following:

   a) an organization referred to in paragraph 1; or

   b) a trust, company, organization or other arrangement referred to in paragraph 2;

   shall be exempt from income taxation in that taxable year in the other Contracting State.

4. The provisions of paragraphs 1, 2 and 3 shall not apply with respect to the income of a trust, company, organization or other arrangement from carrying on a trade or business or from a related person other than a person referred to in paragraphs 1, 2 or 3.

5. A religious, scientific, literary, educational or charitable organization which is resident in Canada and which has received substantially all of its support from persons other than citizens or residents of the United States shall be exempt in the United States from the United States excise taxes imposed with respect to private foundations.

6. For the purposes of United States taxation, contributions by a citizen or resident of the United States to an organization which is resident in Canada, which is generally exempt from Canadian tax and which could qualify in the United States to receive deductible contributions if it were resident in the United States shall be treated as charitable contributions; however, such contributions (other than such contributions to a college or university at which the citizen or resident or a member of his family is or was enrolled) shall not be deductible in any taxable year to the extent that they exceed an amount determined by applying the percentage limitations of the laws of the United States in respect of the deductibility of charitable contributions to the income of such citizen or resident arising in Canada. The preceding sentence shall not be interpreted to allow in any

taxable year deductions for charitable contributions in excess of the amount allowed under the percentage limitations of the laws of the United States in respect of the deductibility of charitable contributions. For the purposes of this paragraph, a company that is a resident of Canada and that is taxable in the United States as if it were a resident of the United States shall be deemed to be a resident of the United States.

7. For the purposes of Canadian taxation, gifts by a resident of Canada to an organization that is a resident of the United States, that is generally exempt from United States tax and that could qualify in Canada as a registered charity if it were a resident of Canada and created or established in Canada, shall be treated as gifts to a registered charity; however, no relief from taxation shall be available in any taxation year with respect to such gifts (other than such gifts to a college or university at which the resident or a member of the resident's family is or was enrolled) to the extent that such relief would exceed the amount of relief that would be available under the Income Tax Act if the only income of the resident for that year were the resident's income arising in the United States. The preceding sentence shall not be interpreted to allow in any taxation year relief from taxation for gifts to registered charities in excess of the amount of relief allowed under the percentage limitations of the laws of Canada in respect of relief for gifts to registered charities.

APPENDIX 2

U.S. MODEL INCOME TAX CONVENTION (2006)

Article 10. Dividends

1. Dividends paid by a company that is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the dividends are beneficially owned by a resident of the other Contracting State, except as otherwise provided, the tax so charged shall not exceed:

   a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company that owns directly at least 10 per cent of the voting stock of the company paying the dividends;

   b) 15 per cent of the gross amount of the dividends in all other cases.

   This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. Notwithstanding paragraph 2, dividends shall not be taxed in the Contracting State of which the company paying the dividends is a resident if:

   a) the beneficial owner of the dividends is a pension fund that is a resident of the other Contracting State; and

   b) such dividends are not derived from the carrying on of a trade or business by the pension fund or through an associated enterprise.

4. a) Subparagraph a) of paragraph 2 shall not apply in the case of dividends paid by a U.S. Regulated Investment Company (RIC) or a U.S. Real Estate Investment Trust (REIT). In the case of dividends paid by a RIC, subparagraph b) of paragraph 2 and paragraph 3 shall apply. In the case of dividends paid by a REIT, subparagraph b) of paragraph 2 and paragraph 3 shall apply only if:

      i) the beneficial owner of the dividends is an individual or pension fund, in either case holding an interest of not more than 10 per cent in the REIT;

      ii) the dividends are paid with respect to a class of stock that is publicly traded and the beneficial owner of the dividends is a person holding an interest of not more than 5 per cent of any class of the REIT's stock; or

      iii) the beneficial owner of the dividends is a person holding an interest of not more than 10 per cent in the REIT and the REIT is diversified.

   b) For purposes of this paragraph, a REIT shall be "diversified" if the value of no single interest in real property exceeds 10 per cent of its total interests in real property. For the purposes of this rule, foreclosure property shall not be considered an interest in real property. Where a REIT holds an interest in a partnership, it shall be treated as owning directly a proportion of the partnership's interests in real property corresponding to its interest in the partnership.

5. For purposes of this Article, the term “dividends” means income from shares or other rights, not being debt-claims, participating in profits, as well as income that is subjected to the same taxation treatment as income from shares under the laws of the State of which the payer is a resident.

6. The provisions of paragraphs 2 through 4 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State, of which the payer is a resident, through a permanent establishment situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 (Business Profits) shall apply.

7. A Contracting State may not impose any tax on dividends paid by a resident of the other State, except insofar as the dividends are paid to a resident of the first-mentioned State or the dividends are attributable to a permanent establishment, nor may it impose tax on a corporation's undistributed profits, except as provided in paragraph 8, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that State.

8. a) A company that is a resident of one of the States and that has a permanent establishment in the other State or that is subject to tax in the other State on a net basis on its income that may be taxed in the other State under Article 6 (Income from Real Property) or under paragraph 1 of Article 13 (Gains) may be subject in that other State to a tax in addition to the tax allowable under the other provisions of this Convention.

   b) Such tax, however, may be imposed:

      i) on only the portion of the business profits of the company attributable to the permanent establishment and the portion of the income referred to in subparagraph a) that is subject to tax under Article 6 or under paragraph 1 of Article 13 that, in the case of the United States, represents the dividend equivalent amount of such profits or income and, in the case of - - - - - - - - , is an amount that is analogous to the dividend equivalent amount; and

      ii) at a rate not in excess of the rate specified in paragraph 2 a).

APPENDIX 3

CANADA-NAMIBIA INCOME TAX CONVENTION (2010)

Article 11

INTEREST

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest.

3. Notwithstanding the provisions of paragraph 2:

   a) interest arising in a Contracting State and paid to, and beneficially owned, by the Government of the other Contracting State or of a political subdivision or local authority thereof, shall be taxable only in that other State;

   b) interest arising in a Contracting State and paid in respect of indebtedness of the government of that State or of a political subdivision or local authority thereof shall, if the interest is beneficially owned by a resident of the other Contracting State, be taxable only in that other State;

   c) interest arising in Namibia and paid to a resident of Canada shall be taxable only in Canada if it is paid in respect of a loan made, guaranteed or insured, or a credit extended, guaranteed or insured by Export Development Canada;

   d) interest arising in Canada and paid to a resident of Namibia shall be taxable only in Namibia if it is paid in respect of a loan made, guaranteed or insured, or a credit extended, guaranteed or insured by a financial institution of a public character with the objective of promoting exports as may be agreed to in writing between the competent authorities of the Contracting States; and

   e) interest arising in a Contracting State and paid to a resident of the other Contracting State that is operated exclusively to administer or provide benefits under one or more pension, retirement or employee benefits plans shall not be taxable in the first-mentioned State provided that

      i) the resident is the beneficial owner of the interest and is generally exempt from tax in the other State, and

      ii) the interest is not derived from carrying on a trade or a business or from a related person.

4. The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such

securities, bonds or debentures, as well as income which is subjected to the same taxation treatment as income from money lent by the laws of the State in which the income arises. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article. The term “interest” also does not include income dealt with in Article 8 or Article 10.

5. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein, and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case, the provisions of Article 7 shall apply.

6. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether the payer is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.

7. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount that would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

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