U.S. tax retaliation measures: What's at stake for Canada's investment sector

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Legislative context

On May 22, 2025, the U.S. House of Representatives passed the *One Big Beautiful Bill Act* (H.R.1), a budget reconciliation package designed in part to extend provisions from prior tax reform efforts and introduce new revenue-generating measures. Among these is the newly proposed Section 899, title *Enforcement of Remedies Against Unfair Foreign Taxes*, which would authorize targeted tax increases on investors in non-U.S. jurisdictions that impose certain types of foreign taxes deemed discriminatory against U.S. businesses. While the House bill must still pass the Senate, where it is likely to undergo changes, and then would have to go back to the U.S. House of Representatives for another vote, Section 899 in its current form has sparked significant concern in Canada's investment sector.

What the measure proposes

Section 899 would authorize the U.S. Treasury to apply increased withholding tax rates on payments made to residents of countries deemed to have enacted "unfair foreign taxes". Specifically, the new Section 899:

- introduces an annual 5 per cent increase in the withholding tax rate on U.S. source payments (such as dividends) until the rate reaches a maximum of 50 per cent (comprising the 20 per cent surtax and existing 30 per cent statutory rate);
- would override existing tax treaty benefits, potentially leading to immediate increases in withholding taxes for Canadian residents;
- would supersede the statutory exemption for foreign governments;
- may apply without access to a foreign tax credit, meaning Canadian funds or their unitholders may not be able to claim a credit for any portion of the U.S. tax imposed above the 15 per cent treaty rate. However, the applicability of the foreign tax credit in Canada remains uncertain.

For example, for Canadian investors, this could translate into an increase from the current 15 per cent dividend withholding tax rate (under the Canada-U.S. tax treaty) to as high as 35 per cent , or even 50 per cent if treaty benefits are denied. The legislation is expected to take effect in 2026.

Why is Canada under the microscope

Canada is likely to fall within the scope of the proposed U.S. measure because of its 2024 digital services tax (DST), which targets revenues linked to U.S. entities. Under the House bill, such taxes are classified as “foreign tax”, triggering potential retaliatory treatment. While other countries have implemented similar measures,[1] Canada’s DST, due to its timing, structure, and lack of carve-outs, appears more vulnerable to being deemed discriminatory under the proposed U.S. regime.

Potential impact on Canadian investment funds

The proposed measure could significantly affect Canadian investors, including investment funds and institutional investors, as well as those earning U.S. source dividend income through registered plans (e.g., RRSPs and RRIFs). Although the Canada-U.S. tax treaty protects certain registered plans and registered pension plans from U.S. withholding tax on dividends, the new surtax under Section 899 may apply regardless of treaty protection–eroding the after-tax return for Canadian investors.

Canadian investment funds and institutional investors could face broader challenges, including reduced attractiveness to foreign investors, increased compliance burdens, and the potential need to restructure portfolios to mitigate exposure to U.S. dividend-paying assets.

Strategic concerns for the fund industry

Industry groups have already engaged or are preparing to engage with the Canadian government to press for the withdrawal or amendment of the DST. But this may be a politically difficult ask, given that the DST is projected to raise $7.2 billion annually, a figure likely to weigh heavily on Ottawa’s policy response.

Section 899 is seen as a negotiating tool in the current U.S. administration’s ongoing tariff battles. Similar to other parts of the Canadian economy, Section 899 may have exposed Canada’s and Canadians overreliance on U.S. markets. Any response from the Canadian government will be shaped by a broader federal government overlay, including fiscal priorities and messaging around economic sovereignty. In response to concerns from the Canadian investment industry, the government may argue that Canada remains an attractive destination for investment, a narrative already deeply embedded in its economic positioning.

What’s next?

While the legislative process remains ongoing, a clearer picture is expected to emerge in the next month, as the Trump administration has pushed a July 4 deadline for signing the bill into law. Much like other provisions contained in the budget reconciliation package, Section 899 may advance in an amended form, or not at all. Despite that uncertainty, the risks for Canadian investment funds and institutional investors are now too concrete to overlook. While they model potential outcomes, they will be paying even closer attention to what happens south of the border.

Footnote

[1] Other countries with digital services taxes include Austria, France, Guinea, Italy, Nepal, Sierra Leone, Spain, Tunisia, Turkey, Uganda, United Kingdom and Zimbabwe.

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