

Tax Memo

Fifth Protocol to the Canada-U.S. Treaty: Technical Explanation

On July 10, 2008, the U.S. Treasury Department released the Technical Explanation of the fifth Protocol to the Canada-U.S. Income Tax Convention (Treaty) to provide guidance with respect to many questions relating to the application of the Protocol. Canada's Minister of Finance commented that Canada has reviewed the U.S. document and agrees that it "accurately reflects understandings reached in the course of negotiations with respect to the interpretation and application of the various provisions in the Protocol."

This *Tax Memo* highlights key points made in the Technical Explanation, as well as some of the important questions that still remain unanswered.

The Protocol will come into force on the day both governments formally notify each other that their procedures are complete. However, before this can occur, the United States must ratify it. Canada has already done so. For more information on the Protocol, see the following *Tax Memos* at www.pwc.com/ca/taxmemo:

- Canada-U.S. Income Tax Treaty: Fifth Protocol Makes Major Changes (*September 24, 2007*): and
- Fifth Protocol to the Canada-U.S. Income Tax Treaty—Reflections (*October 3, 2007*).

International Tax

Limited Liability Companies—Treaty Article IV(6)

Article 2 of the Protocol adds new paragraph 6 into Article IV to extend Treaty benefits to income, profit or gain derived by a person through a fiscally transparent entity, if certain conditions are met.

Definition of "fiscally transparent"

The Technical Explanation clarifies the definition of "fiscally transparent" by noting that fiscally transparent entities are in general entities, the income of which is taxed at the beneficiary, member or participant level.

For U.S. tax purposes, fiscally transparent entities include partnerships, certain investment trusts, grantor trusts and business entities, such as a limited liability company (LLC) that is treated as a partnership or is disregarded as an entity separate from its owner for U.S. tax purposes. For Canadian tax purposes, fiscally transparent entities include (except to the extent the law provides otherwise) partnerships and what are known as "bare" trusts. Based on the Technical Explanation, trusts that are not considered bare trusts are not fiscally transparent entities.

Because Canada ordinarily accepts that an S corporation is resident in the U.S. for purposes of the Treaty, Canada will allow benefits under the Treaty to an S corporation, (regardless of Article IV(6)) even though an S corporation is considered fiscally transparent under U.S. tax law.

Treatment of income, profit or gain

For Treaty benefits to be extended to a fiscally transparent entity, the treatment of the income, profit or gain must be "the same as its treatment would be" if the income, profit or gain had been derived directly by the owner.

The Technical Explanation states that whether an amount is treated the "same as" its treatment if derived directly is determined based on the principles set forth in IRC section 894 and the regulations under that section concerning whether an entity will be treated as fiscally transparent with respect to an item of income. The Technical Explanation specifically cites that the regulations require an amount to be:

- separately taken into account;
- on a current basis;
- in proportion to the owner's respective share of the income (whether or not distributed); and
- with the character and source determined as if such item were realized directly.

Although Canada does not have analogous provisions in its domestic law, the Technical Explanation states that principles comparable to those described above will apply.

LLC remains taxpayer

The Technical Explanation clarifies that Canada will determine the entitlement of a U.S. resident to the benefits of the Treaty within its own legal framework. In the context of an LLC, the Canadian tax treatment of the LLC may be modified because of the entitlement of its members to benefits under the Treaty. This does not alter the LLC's status as the only Canadian taxpayer because, under Canada's legal framework, the LLC is treated as a corporation rather than as a partnership or disregarded entity.

This has a number of implications, including the following:

- Canada will not require the members of the LLC to file Canadian tax returns in respect of income benefitting from Article IV(6). The LLC retains the obligation to file a Canadian tax return in which it will claim the benefit of the Treaty on the portion of its

income entitled to Treaty benefits and supply any documentation required to support the claim.

- The determination of whether the LLC has a permanent establishment in Canada will be based on the presence and activities in Canada of the LLC itself, not of its members acting in their own right. (When a person is considered to derive income through an entity, the U.S. looks to the activities of both the entity and the person to determine whether a permanent establishment exists.)

The Technical Explanation does not clarify whether dividends paid to an LLC that is owned by a U.S.-resident individual will qualify for the reduced dividend withholding tax rate available to corporate shareholders owning at least 10% of the voting stock of the LLC. If Article IV(6) determines only the entitlement of the LLC to Treaty benefits, then arguably it should not apply to prevent an LLC from qualifying for the reduced dividend withholding tax rate.

Future guidance from the Canada Revenue Agency

The Technical Explanation specifically states that the Canada Revenue Agency (CRA) will supply additional practical guidance regarding filing a Canadian tax return to claim Treaty benefits, including instructions for seeking to establish entitlement to Treaty benefits in advance of payment. It remains to be seen whether this guidance will:

- address the nature of the information that needs to be obtained from a non-resident person in order to allow the payer to reduce the rate of withholding tax on a payment;
- clarify the principals used to determine whether an amount is treated the "same as" its treatment if derived directly; and
- clarify the allocation of income between income qualifying for Treaty benefits and that which does not.

Hybrid entities—Treaty Article IV(7)

Inbound application

The Protocol introduces paragraph 7 into Article IV to deny Treaty benefits when income, profit or gain is paid to or derived by entities that are fiscally transparent in one country but not the other. For example, paragraph 7(a) denies Treaty benefits if:

- a resident of the United States derives a dividend or interest through an entity, such as a partnership, that

is viewed as fiscally transparent by Canada but not by the United States; and

- the U.S. tax treatment of the amount under U.S. law is different than would have been the case if the income had been earned directly.

As a result, the payment to the Canadian partnership will be subject to withholding tax at 25%. The Technical Explanation gives examples of structures to which this rule is expected to apply, including a situation in which a U.S. company derives Canadian-source dividends through a Canadian limited partnership that is considered to be a corporation for U.S. tax purposes.

Paragraph 7(b) denies benefits when a resident receives income, profit or gain from an entity that is fiscally transparent under the laws of the recipient's country but not the source country. The Technical Explanation provides several examples. Unfortunately, this provision is broadly worded and will apply to many situations when there is no perceived abuse. For example, Treaty benefits will be denied for U.S. residents receiving dividends from a Canadian corporation that is disregarded for U.S. tax purposes, even though there is no double-dip of a deductible payment. The denial will extend to structures used for legitimate business reasons, including a U.S. company that uses a Canadian unlimited liability company (ULC) as an operating entity.

The staff report of the Joint Committee on Taxation released on July 8, 2008, recognized that the scope of paragraph 7(b) may be too broad and suggested that the Senate Committee "may wish to inquire whether a rule might have been negotiated in lieu of subparagraph 7(b) that would have more narrowly targeted abusive cross-border structures while at the same time causing less disturbance to non-abusive structures."

The Technical Explanation does not provide any relief to alleviate the broad application of paragraph 7(b). Taxpayers should therefore review any structures that include hybrid entities to determine whether changes are required before the January 1, 2010 effective date, assuming the protocol enters into force in 2008.

Outbound application

The Technical Explanation indicates that treaty benefits would be denied when a Canadian resident owns a U.S. entity that is fiscally transparent for U.S. tax purposes (i.e., a U.S. LLC) and receives U.S. source income. The reference to U.S. source income presumably includes

both business profits and passive income. Accordingly, treaty benefits should be denied and the U.S. branch profits tax levied at a rate of 30% when a Canadian corporation uses an LLC to conduct business in the United States. A similar conclusion would presumably apply to a foreign entity, for example a Barbados SRL, which is fiscally transparent for U.S. tax purposes, such that a Canadian corporation that uses a Barbados SRL to access the Canada-US treaty would be denied those treaty benefits.

The Technical Explanation confirms that a dividend paid by a U.S. limited partnership that is considered a corporation for U.S. tax purposes will be denied treaty benefits. Accordingly, paragraph 7(b) should apply to increase the withholding tax rate on distributions from tower structures to the U.S. domestic rate of 30%.

Deemed permanent establishment rules for service providers— New Article V(9)

New Article V(9) can deem an enterprise to be "providing services through a permanent establishment in the other State" if certain conditions are met. If the Protocol is ratified in 2008, new Article V(9) will be effective for taxation years starting January 1, 2010, for enterprises with a calendar taxation year.

The Technical Explanation states that paragraph 9 applies only to services provided by an enterprise to "third parties." This choice of words is interesting, because normally a "third party" is synonymous with "unrelated" or "arm's-length." However, the words of paragraph 9 appear to apply to services provided to any customer, even related parties.

The Technical Explanation does not specifically address whether days on which services are provided in a State by an enterprise's subcontractors could count in determining whether the enterprise meets the 183-day threshold in Article V(9)(b). Most likely, an enterprise would have to send its own employees to the other State to render services to the customer in order for it to "provide services" in the other State (as referred to in the preamble of paragraph 9). The Technical Explanation clarifies that a given day can be counted only once for the purposes of the 183-day threshold, even if more than one employee is present in a State on that day.

The Technical Explanation provides some examples of "connected projects" for purposes of Article V(9)(b). It confirms that the determination should be made from the

point of view of the service provider (not the customer), based on the facts and circumstances.

The Technical Explanation clarifies that, with respect to Article V(9), the determination of business profits under Article VII would be only in respect of the services that are deemed to be provided through a permanent establishment in the other State. Accordingly, other revenues earned by the enterprise from that same State should not be included as part of those business profits. For example, this would be the case for revenues from:

- the sale of products;
- providing services in respect of a non-connected project; or
- providing services to customers that are not resident (and do not have a permanent establishment) in that State.

The Technical Explanation "encourages" the competent authorities to consider adopting rules to reduce the potential for excess withholding or estimated tax payments with respect to employee wages that could result from the application of paragraph 9. An area of equal concern not addressed in the Technical Explanation is the potential for penalties and interest charges for failure to meet these employee tax obligations (even if the employee's wages are not taxable because of Article XV). However, this raises the possibility that changes may be forthcoming to address the cumbersome "Regulation 102" rules under the *Income Tax Act*.

Withholding on interest—Treaty Article XI

The Technical Explanation confirms that the reduced withholding tax rates on interest paid to both related and unrelated parties will be retroactive. For example, if the Protocol is ratified in 2008, the 7% withholding tax rate on payments of interest to related parties will apply to payments made on or after January 1, 2008, with an exemption from withholding tax for payments made after January 1, 2010.

New bilateral limitation of benefits rule—Treaty Article XXIX A

There were few surprises in the Technical Explanation to the limitation of benefits (LOB) provisions, and many uncertainties remain.

Qualifying person tests

Paragraph 2 provides that a resident of Canada or the United States that is a "qualifying person" is entitled to all benefits accorded by the Treaty.

Subparagraph (2)(c) specifically provides that a company or trust that is resident of Canada or the United States is a qualifying person if the principal class of its shares or units (including any disproportionate class of shares or units) is "primarily and regularly traded" on one or more recognized stock exchanges. Unexpectedly, the Technical Explanation states that, subject to the adoption by Canada of other definitions, Canada will accept the U.S. interpretation of the terms "primarily traded" and "regularly traded," with modifications as circumstances require, for purposes of subparagraph 2(c).

Under subparagraph 2(e), a company or trust that is resident of Canada or the United States is entitled to Treaty benefits if it satisfies both an ownership test and a base erosion test. The ownership test in this subparagraph is satisfied if 50% or more of the entity's aggregate voting power and value, including 50% or more of any disproportionate class of its shares (in neither case including debt substitute shares) are not owned, "directly or indirectly," by persons other than qualifying persons.

The Technical Explanation states that the ownership test is intended to clarify that the test is not satisfied if, for example, a Canadian company is more than 50% owned by a U.S. resident company that is, itself, wholly-owned by a third-country resident. In this case, the Canadian company does not meet the ownership test because more than 50% of its shares are indirectly owned by a person (i.e., the third-country resident) that is not a qualifying person.

The example clarifies that the indirect ownership test should be applied to the entire chain of ownership up to the top level for the presence of indirect non-qualifying shareholders. This position contrasts with the affirmatively worded "directly or indirectly" test in subparagraph 4(a), which implies that it is sufficient to look up the chain of ownership until one finds a group of indirect shareholders that meets the requirement of this subparagraph.

As anticipated, the Technical Explanation clarifies that "look-through" principles introduced by the Protocol, for example, under paragraph 6 of Article IV, should be applied in conjunction with the ownership and base erosion provisions contained in subparagraphs 2(d) and (e). (At the Canadian IFA Branch Seminar held on

May 12, 2008, the CRA confirmed that it would accept the “look-through” approach when applying the ownership and base erosion provisions in subparagraphs 2(d) and (e). The CRA recommended that the Technical Explanation reflect this interpretation.)

For instance, when a recipient U.S.-resident company or trust is not the ultimate owner and there are fiscally transparent U.S. entities between the ultimate U.S. qualifying person and the recipient, the Technical Explanation indicates that fiscally transparent entities should be ignored in determining the qualifying person. For example, suppose a U.S.-resident individual owns a U.S. LLC, which in turn owns a U.S. C corporation, and the U.S. C corporation wishes to obtain Treaty benefits in respect of Canadian source income it receives. The Technical Explanation states that the U.S. individual would be treated as the U.S. C corporation’s owner for purposes of subparagraphs 2(d) and (e). Thus, the U.S. C corporation would satisfy the ownership requirements in subparagraph 2(e).

Active business test

Paragraph 3 of the LOB article provides Treaty benefits for income derived from the other contracting state if, among other things:

- the income is earned “in connection with” or “incidental to” a trade or business carried on in the residence country; and
- the trade or business in the residence country is “substantial” in relation to the activity carried on in the other contracting state.

The Technical Explanation provides no additional insight as to whether the scope of paragraph 3 is limited to items of income only or whether Treaty benefits should extend to gains under Article XIII. For the most part, the new Technical Explanation with respect to paragraph 3 remains virtually identical to the Technical Explanation to the fourth Protocol to the Treaty, except that paragraph 3 now has reciprocal application.

Trade or business

The term “trade or business” is not defined in the Protocol and the Technical Explanation does not elaborate on its meaning. Undefined terms should have the meaning that they have under the law of the country that applies the provision. Therefore, for U.S. tax purposes, the term “trade or business” should have the same meaning as Section 367(a) of the Internal Revenue Code. However, Canada has not adopted the U.S. interpretation of the

term “trade or business” and therefore this term should have the meaning it has under the laws of Canada.

“In connection with” or “incidental to”

The Technical Explanation does elaborate on the requirement that an item of income from the source country be derived “in connection with” or “incidental to” the resident country’s trade or business. An item of income is derived in connection with a trade or business if, for example, the income-producing activity in the source country is upstream, downstream or parallel to the activity conducted in the other country. Furthermore, income is considered incidental to a trade or business if, for example, it arises from the short-term investment of working capital of the resident in securities issued by persons in the source country.

The Technical Explanation also states that income may be considered to be earned “in connection with” or “incidental to” an active trade or business in one of the Treaty countries, even though the resident claiming the benefits derives the income directly or indirectly through one or more persons that are residents of the other Treaty country. The example in the Technical Explanation states that a Canadian resident could claim benefits with respect to an item of income earned by a U.S. operating subsidiary, but derived by the Canadian resident through a wholly-owned U.S. holding company interposed between it and the U.S. operating subsidiary.

Presumably the above example is referring to dividends ultimately received by the Canadian resident that were earned in connection with the active trade or business carried on by the U.S. operating subsidiary. However, the Technical Explanation does not clarify whether, in appropriate circumstances, interest income earned by a resident country from a source country could be earned “in connection with” the active trade or business carried on by the source country.

“Substantial”

In addition to the income being derived “in connection with” or “incidental to” an active trade or business in a contracting state, a “substantiality” requirement must be met to qualify for Treaty benefits. This requirement is intended to prevent a narrow case of Treaty-shopping abuses when companies attempt to qualify for benefits by engaging in insignificant connected business activities (i.e., activities that have little economic cost or effect with respect to the business as a whole).

The Technical Explanation states that it is not necessary that the trade or business in the residence country be as large as the income-producing activity in the source country to meet this substantiality requirement. However, it does state that, in terms of income, assets or other similar measures, the trade or business in the residence country cannot be a very small percentage of the activity in the source country.

Derivative benefits test

A company that does not satisfy any of the other LOB tests may nevertheless qualify for Treaty benefits in respect of dividends, interest and royalties, if certain conditions are satisfied under the derivative benefits clause. As anticipated, no further comments were released in the Technical Explanation on this requirement.

Transfer Pricing

Attributing profits to a permanent establishment—Treaty Article VII

The Technical Explanation confirms that the business profits attributable to a permanent establishment:

- include only those profits derived from the assets used, risks assumed and activities performed that the permanent establishment might be expected to earn if it were a distinct and separate person; and
- are to be determined by following the OECD Transfer Pricing Guidelines.

The Technical Explanation also states that notional costs, such as royalties and interest, used to compute the profits of a permanent establishment will not be taxed as if they were actual payments, for purposes of other taxing provisions of the Treaty.

A permanent establishment must be allocated sufficient capital to carry on its activities, which may limit the amount of interest allocated. While the Protocol mentions the risk-weighted capital allocation method for financial institutions, the Technical Explanation allows taxpayers to apply the principles of Treas. Reg. section 1.882-5(c) to ease the administrative burden, provided the result is in accordance with the arm's-length principle.

Arbitration—Treaty Article XXVI

The Protocol indicates that the arbitration process will generally begin two years after a case is accepted, if the competent authorities are unable to reach a resolution. For current cases, the two-year period starts on the date the Protocol enters into force. To avoid a large number of the current cases going to arbitration at one time after the initial two-year period expires, the Technical Explanation encourages the competent authorities to:

- develop and implement procedures for arbitration by January 1, 2009; and
- begin scheduling otherwise unresolvable Mutual Agreement Procedure (MAP) cases, subject to meeting the agreed criteria, before two years from the entry into force.

As a result, cases can theoretically proceed to arbitration in less than one year from the entry into force. Because the competent authorities are authorized to amend the process as it unfolds, perhaps many remaining questions will be answered as changes are made.

The Technical Explanation also provides some minor clarifications on the arbitration process, for example, with respect to confidentiality rules for the arbitration board members and staff and for the competent authorities.

Personal Tax

Income from employment—Treaty Article XV

183-day rule

The Technical Explanation confirms that remuneration for services rendered in the other country will be subject to taxation in the other country if the individual has been present in that other country for more than 183 days in a 12-month period. This differs from existing Article XV, which bases the test on 183 days in the calendar year.

The current Treaty also provided a safe harbour rule that excludes remuneration if the amount paid for the services is less than \$10,000. The Technical Explanation clarifies that this test will still be available and will continue to be applied on a calendar-year basis.

Economic employer

The Technical Explanation indicates that the change in the definition with respect to remuneration “borne by” a permanent establishment in the other country has been

modified to prevent certain abusive cases and is intended to reflect the provisions in the U.S. and OECD Model Treaties. The Technical Explanation explicitly states that “borne by” means “allowable as a deduction in computing taxable income.”

Pensions and annuities—Treaty Article XVIII

The Protocol adds provisions to permit the deduction of cross-border pension contributions by employees and employers. There are no comparable rules in the OECD Model Treaty.

The new pension contribution rules will apply to:

- individuals on a short-term assignment (60 months or less) in the other country who continue to participate in their home country “qualifying retirement plan”;
- cross-border commuters who live in one country and work in the other; and
- U.S. citizens resident in Canada who participate in a Canadian qualifying retirement plan.

The Technical Explanation points out that the rules are structured so that individuals who use the Treaty provisions will not be in a more favourable position than those who are ordinarily residents or taxpayers in the host country. In addition, individuals will not be permitted to “double dip.” Contributions to both a home and host country plan will not be permitted with respect to the same services.

Miscellaneous rules—Treaty Article XXIX

Article XXIX of the Treaty, which permits the United States to tax U.S.-source income of former citizens for ten years after the relinquishment of citizenship, has been expanded to include former “long-term residents.” The change clarifies that the Treaty was to conform to the U.S. taxation of former citizens and long-term residents under IRC section 877.

On June 17, 2008, section 877 was modified to replace the former rules with an “exit tax” regime for expatriation on or after that date. The new IRC provisions deem the individual to waive any rights to claim benefits under a U.S. Tax Treaty. However, the Treaty provision will continue to apply for individuals who relinquished U.S. citizenship or ceased to be a lawful permanent resident before June 17, 2008.

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