Tax Memo

PRICEWATERHOUSECOOPERS

Canada-U.S. Income Tax Treaty: Fifth Protocol Makes Major Changes

On Friday, September 21, 2007, after nearly 10 years of negotiation, the United States and Canada jointly released the fifth Protocol[1] (the Protocol) to the *Canada-U.S. Income Tax Convention* (Treaty).

The Protocol will have a significant effect on individuals, as well as on Canadian multinationals with U.S. operations and U.S. multinationals with operations in Canada. It includes some surprises. However, as previously announced in Canada's 2007 federal budget and in a September 2000 Department of Finance press release, the Protocol:

- eliminates withholding taxes on interest;
- extends treaty benefits to owners of Limited Liability Companies (LLCs);
- modifies the rules dealing with residence and corporate emigration; and
- changes the way in which various personal tax considerations are handled.

This *Tax Memo* highlights the Protocol's key changes. Another *Tax Memo,* providing a more comprehensive analysis of the Protocol, will be issued shortly.

Entry into force

The Protocol will enter into force on the later of January 1, 2008, and the day both governments have completed their respective constitutional and statutory procedures and have exchanged instruments of ratification. Therefore, to be effective commencing January 1, 2008, the Protocol must be ratified in both countries by the end of 2007. Although both Minister Flaherty and Secretary Paulson have indicated a desire to complete ratification procedures as soon as possible, it is uncertain whether the U.S. will be able to do so in 2007. If not, the U.S. ratification process likely will occur early in 2008.

Although some changes in the Protocol are retroactive, the provisions of the Protocol will generally apply:

- for purposes of non-resident withholding tax, to amounts paid or credited on or after the first day of the second month that begins after the Protocol's entry into force (e.g., to amounts paid or credited on or after March 1, 2008, if entry into force occurs on January 1, 2008); and
- for other taxes, if entry into force is:
  - on January 1, 2008, to taxable years beginning in 2008 or later; or
  - after January 1, 2008, to taxable years beginning after the calendar year in which the Protocol enters into force.

Withholding taxes

Interest

As announced by Minister Flaherty in his 2007 federal budget, the Protocol eliminates withholding tax on cross-border interest payments between arm's length persons. The elimination of withholding tax on interest paid between related persons will be phased in over three years, as follows:

- the current 10% withholding tax rate will be reduced to 7% for the portion of the calendar year between the date the exemption becomes effective and the end of the year;

1. The Protocol includes Annexes A and B.

- the 7% rate will be reduced to 4% for the immediately following calendar year; and
- the tax will be eliminated for subsequent calendar years.

New exceptions

This withholding tax exemption on interest will be subject to new exceptions. A maximum withholding tax rate of 15% (i.e., the general dividend withholding tax rate) will apply to:
- "contingent interest" arising in the U.S. that does not qualify as portfolio interest under the U.S. portfolio interest exemption; and
- "participating interest" arising in Canada (interest determined with reference to receipts, sales, income, profits or other cash flow of a change in value).

When a special relationship exists between the payer and the beneficial owner, the portion of any interest payments exceeding an arm's length rate will continue to be ineligible for Treaty benefits.

Corollary changes

The 2007 federal budget also indicated that the Canadian domestic tax rules will be amended to eliminate withholding tax on interest paid to **all** arm's length non-residents. We understand that this change is intended to be effective on the same date that the withholding tax on interest paid to unrelated U.S. residents is eliminated under the Treaty; however, this will not be clear until legislation is introduced.

Dividends

Unlike many treaties recently negotiated by the U.S., the Protocol does not eliminate source country taxation of dividends. It retains the traditional 15% rate, reduced to 5% when the recipient company owns 10% or more of the voting shares of the company paying the dividends.

New "look-through" rules

A change clarifies that the reduced (5%) rate of withholding tax applies to dividends paid by a Canadian company when the shares of the Canadian company are owned by a U.S. company through a partnership or LLC. For purposes of determining whether the 10% ownership requirement is met, a new "look through" rule in the Protocal applies when the shares of the company paying the dividends are owned by an "entity" that is considered fiscally transparent under the laws of the receiving state (as long as the "entity" is not a resident of the contracting state of which the company paying the dividends is a resident). Further, this look through rule is available only to a resident of the U.S. that has an interest in a fiscally transparent entity if that resident is a corporation.

Distributions from U.S.-based REITs

Distributions from a U.S.-based Real Estate Investment trust (REIT) will be covered by the dividends article. REIT distributions to individuals will be subject to 15% withholding tax if the ownership is 5% or less, or for a trust that is a diversified REIT, if the ownership is 10% or less. Other REIT distributions will be subject to withholding at the U.S. domestic rate of 30%.

Royalties

The Protocol does not change the rate of withholding on royalties, which is 10% or zero, depending on the nature of the royalty.

Permanent establishments

The Protocol includes a change to the permanent establishment (PE) article that will deem an enterprise of a contracting state that otherwise does not have a PE in the other state to have a PE in that state if it provides services in the other state and:
- the services are:
  - performed in the other state by an individual who is present in the other state for a period of 183 days or more in any 12-month period; and
  - during that period, more than 50% of the gross active business revenues of the enterprise consists of income derived from the services performed; **or**
- the services are provided in the other state for an aggregate of 183 days or more in any 12-month period with respect to the same or connected project for customers who either:
  - are residents of the other state; or
  - maintain a PE in the other state, and the services are provided in respect of that PE.

The deemed PE changes do not apply when the PE determination is for a building site or construction or installation project covered by paragraph 3 of Article V. For those activities, the 12-month threshold is preserved.

These changes will be in effect the third taxable year that ends after the Protocol enters into force and any activity before January 1, 2010 (days presence, days service or gross revenue) is to be ignored in making the PE determination. In essence, the changes generally will apply no sooner than January 1, 2010.

Business profits

The Protocol clarifies that Canada and the U.S. have adopted the current Organisation for Economic Co-operation and Development (OECD) authorized approach to attribution of profits to a permanent establishment.

U.S. limited liability companies and other fiscally transparent entities

The Canada Revenue Agency's long-standing view has been that limited liability companies (LLCs) treated as fiscally transparent or "disregarded" for U.S. income tax purposes are not resident in the U.S. for purposes of the Treaty. As announced in the 2007 federal budget, the Protocol generally extends Treaty benefits to U.S. LLCs and partnerships if a member or partner is a U.S. resident for purposes of the Treaty. This amendment will allow U.S. investors more flexibility in structuring Canadian investments.

Hybrid entities – denial of Treaty benefits

The Protocol introduces new rules that have the effect of denying treaty benefits when income, profits or gains are derived:

- "through" a hybrid entity; i.e., an "entity" that is treated as fiscally transparent under the tax rules of the source country, but as a separate entity under the tax rules of the other country. (This rule seems to be aimed at certain inbound to Canada financing structures such as the "synthetic NRO.") or
- "from" a hybrid entity; i.e., an entity that is treated as a separate entity under the tax rules of the source country, but as fiscally transparent under the tax rules of the other country. (This rule would apply to amounts derived by a U.S. parent company from entities such as an unlimited liability company which is disregarded for U.S. tax purposes.)

These rules may also affect certain outbound from Canada financing and holding structures when a Canadian company has an investment in a "hybrid entity." For example, it appears the rules will apply to distributions from "Tower" structures beginning January 1, 2010 (at the earliest).[2] As a result, the tax cost inherent in a "Tower" structure would increase marginally.

2. On May 14, 2007, the Department of Finance announced its "Anti-Tax-Haven Initiative," which included proposals to "shut down" the "Tower" beginning in 2012.

Cross-border structures used by Canadian and U.S. companies should be reviewed in light of these changes.

Limitation of benefits

The limitation of benefits (LOB) provisions in the current Treaty apply only for the purposes of the application of the Treaty by the U.S. The Protocol revises the LOB provisions and, more importantly, ensures Canada can now apply these provisions. This introduces Canada's first comprehensive LOB provision and, apparently, a new approach to combat "treaty shopping."

The revised LOB provisions retain the general abuse provision that "clarifies" the right of a contracting state to deny treaty benefits if it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Treaty. It remains to be seen under what circumstances this provision will allow either contracting state to deny treaty benefits to a company that would otherwise not be denied benefits under the LOB article.

Mandatory arbitration

The Protocol adds a binding arbitration procedure, described as "mandatory arbitration," for the resolution of competent authority disputes. Eventually, this mandatory arbitration procedure should allow competent authority cases to be resolved for quickly.

Guarantee fees

The Protocol eliminates source country taxation of financial guarantee fees (i.e., guarantees of debt obligations) unless the fees constitute business profits attributable to a permanent establishment of the payee maintained in the payor's country of residence.

Pension contributions

To accommodate the movement of employees between the two countries without impairing pension benefits, the Protocol modernizes the treatment of contributions to, and benefits accrued in, certain cross-border pensions and annuities. The changes affect individuals who:

- reside in one country and work in the other and contribute to a pension plan (or certain other employment-related retirement arrangements) in the country where they work; or
- move from one country to the other on short-term (up to five years) work assignments and continue to contribute to a plan or arrangement.

Stock options

The Protocol clarifies the sourcing of stock option benefits for employees who:

- are granted employee stock options while employed in one country; and
- subsequently work for the same or a related employer in the other country before exercising or disposing of the option (or disposing of the share).

The option benefit will generally be sourced proportionately based on the location of the individual's principal place of employment during the time between the granting of the option and its exercise (or the disposition of the share).

Emigrants' gains

The Protocol prevents the double taxation of pre-emigration gains on property held by an individual at the date of emigration. It allows an individual who ceases to be resident in one country and is treated as having disposed of a property by that country to choose to have the deemed disposition and reacquisition also apply in the new home country. This provision applies to dispositions (i.e., emigrations) after September 17, 2000.

Article XIV, "Independent Personal Services" deleted

The Protocol deletes Article XIV, "Independent Personal Services." This deletion is based on the understanding that no practical distinction can be made between a "fixed base" and a "permanent establishment." The provisions of Article VII, "Business Profits" (as amended by the Protocol), should apply to the activities of an individual resident in one contracting state found to have a permanent establishment in respect of those activities in the other contracting state.

PricewaterhouseCoopers contacts

Please contact any of the following individuals for more information on this topic.

Alberta			
Calgary	Murray Lee	403 509 7576	*murray.lee@ca.pwc.com*
	Dale Meister	403 509 7584	*dale.s.meister@ca.pwc.com*
British Columbia			
Vancouver	Michael Balaski	604 806 7073	*michael.e.balaski@ca.pwc.com*
	Paul Bush	604 806 7021	*paul.bush@ca.pwc.com*
	Bettina Charpentier	604 806 7026	*bettina.charpentier@ca.pwc.com*
	William Holms	604 806 7052	*william.holms@ca.pwc.com*
	Lincoln Schreiner	604 806 7713	*lincoln.schreiner@ca.pwc.com*
	Michael Shields	604 806 7802	*michael.shields@ca.pwc.com*
Quebec			
Montreal	Jay Black	514 205 5033	*jay.black@ca.pwc.com*
	Pierre Bourgeois	514 205 5139	*pierre.bourgeois@ca.pwc.com*
Ontario			
Toronto	Paul Barnicke	416 869 2369	*paul.l.barnicke@ca.pwc.com*
	Ken Buttenham	416 869 2600	*ken.buttenham@ca.pwc.com*
	Stephen Dunk	416 365 8239	*steve.dunk@ca.pwc.com*
	Mike Maikawa	416 365 2719	*mike.maikawa@ca.pwc.com*
	Andy McAskile	416 869 8725	*andrew.mcaskile@ca.pwc.com*
	Nick Pantaleo	416 365 2701	*nick.pantaleo@ca.pwc.com*
	Phyllis Roy	416 815 5034	*phyllis.r.roy@ca.pwc.com*
	Lloyd Sparling	416 365 8185	*lloyd.c.sparling@ca.pwc.com*
Toronto North	David Grosman	416 218 1474	*david.grosman@ca.pwc.com*

Other PricewaterhouseCoopers contacts across Canada

Alberta			
Calgary	Dale Meister	403 509 7584	*dale.s.meister@ca.pwc.com*
Edmonton	Dan Woodruff	780 441 6810	*daniel.a.woodruff@ca.pwc.com*
British Columbia			
Vancouver	Brad Sakich	604 806 7730	*brad.a.sakich@ca.pwc.com*
Manitoba			
Winnipeg	David Loewen	204 926 2428	*dave.loewen@ca.pwc.com*
Maritimes			
Saint John/Halifax	Dean Landry	506 653 9427	*dean.landry@ca.pwc.com*
Newfoundland and Labrador			
St. John's	Allison Saunders	709 722 3883	*allison.j.saunders@ca.pwc.com*
Quebec			
Montreal	Pierre Lessard	514 205 5034	*pierre.lessard@ca.pwc.com*
Quebec City	Claude Laforce	418 691 2439	*claude.laforce@ca.pwc.com*
Ontario			
Hamilton	Jason Safar	905 972 4118	*jason.safar@ca.pwc.com*
Kitchener/Waterloo	Mark Walters	519 570 5755	*mark.g.walters@ca.pwc.com*
London	Tom Mitchell	519 640 7916	*tom.r.mitchell@ca.pwc.com*
Mississauga	Betty Ann Jarrett	905 949 7314	*betty.ann.jarrett@ca.pwc.com*
Ottawa	Kent Davison	613 755 4346	*kent.davison@ca.pwc.com*
Toronto	Brenda Humphreys	416 814 5765	*brenda.j.humphreys@ca.pwc.com*
Toronto North	Louis Provenzano	416 218 1563	*louis.j.provenzano@ca.pwc.com*
Windsor	Debbie Meloche	519 985 8910	*debbie.d.meloche@ca.pwc.com*
Saskatchewan			
Saskatoon	Frank Baldry	306 668 5910	*frank.m.baldry@ca.pwc.com*

© 2007 PricewaterhouseCoopers LLP. All rights reserved. "PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP, an Ontario limited liability partnership, or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity.

This publication is intended to inform readers of developments as of the date of publication, and is neither a definitive analysis of the law nor a substitute for professional advice. Readers should discuss with professional advisers how the information may apply to their specific situations.

This publication may be displayed or printed only if for personal non-commercial use and unchanged (with all copyright and other proprietary notices retained). Unauthorized reproduction is expressly prohibited.