

Tax Law Bulletin January 2009 Fifth Protocol to Canada-U.S. Tax Treaty Now In Force

The Fifth Protocol (the "Protocol") to the *Canada-U.S. Income Tax Convention* (the "Treaty") entered into force on December 15, 2008. The Protocol was the result of 10 years of negotiation between the two countries. This Bulletin summarizes some of the more significant amendments to the Treaty contained in the Protocol. It is important to note that the effective implementation dates of the various provisions in the Protocol vary and not all of the amendments to the Treaty contained in the Protocol come into force at the same time.

Subject Matter of Protocol	Effective Date
Elimination of Withholding Tax on Interest	<ul style="list-style-type: none"> • Retroactive to January 1, 2008 for arm's length non-participating interest paid or credited • For non-arm's length interest paid or credited (other than participating interest), withholding rates are: <ul style="list-style-type: none"> • 7% in 2008 • 4% in 2009 • 0% in 2010 and subsequent years
Guarantee Fees	<ul style="list-style-type: none"> • No withholding tax on guarantee fees paid on indebtedness on or after February 1, 2009
Extension of Treaty Benefits to LLCs and other Fiscally Transparent Entities	<ul style="list-style-type: none"> • Effective on February 1, 2009 for source withholding tax purposes • Effective for taxable years that begin after 2008 for capital gain and permanent establishment exemptions.
Dividends Earned Through Flow-Through Entities	<ul style="list-style-type: none"> • Effective for dividends paid on or after February 1, 2009
ULCs – Denial of Treaty Benefits	<ul style="list-style-type: none"> • January 1, 2010
Permanent Establishment for Service Providers	<ul style="list-style-type: none"> • Effective on the 3rd taxation year of an enterprise that ends after December 15, 2008
Limitation on Benefits	<ul style="list-style-type: none"> • Effective on February 1, 2009 for source withholding tax purposes • Effective for taxable years commencing after 2008 for all other income tax purposes
Stock Option Benefit Apportionment Rules	<ul style="list-style-type: none"> • Effective on December 15, 2008

Elimination of Withholding Tax on Interest

Effective on January 1, 2008, amendments to the *Income Tax Act* (Canada) eliminated withholding tax on non-participating interest payments made to **arm's length** non-residents of Canada, regardless of the country of residence. In addition, the Protocol provides for the elimination of withholding tax, effective as of January 1, 2008, on interest paid to an arm's length resident of the other state, except for participating interest payments.

As a result of the Protocol, the payment of non-participating interest by Canadian residents to **non-arm's length** U.S. lenders will now be eligible for reduced Canadian withholding tax rates which will be phased in over three (3) years as follows:

- Interest paid in 2008 – 7%
- Interest paid in 2009 – 4%
- Interest paid in 2010 and subsequent years – 0%

If Canadian withholding tax had been withheld on non-participating interest payments made to a non-arm's length U.S. lender during 2008 at the 10% rate, then the U.S. resident lender will be entitled to request a refund of the excess withholding tax.

Commencing February 1, 2009, the rate of Canadian withholding tax on participating interest payments will, by virtue of the Protocol, be subject to a 15% rate of withholding tax. Participating interest is interest determined with reference to: (i) receipts, sales, income, profits or other cash flow of the borrower or a related person, (ii) any change in the value of any property of the borrower or a related person, and (iii) any dividend, partnership, distribution or similar payment made by the borrower or a related person.

Guarantee Fees

Under the Protocol, guarantee fees paid on indebtedness (but not other types of guarantee fees) are taxable only in the recipient's country of residence and are exempt from withholding tax, unless such fees are attributable to a permanent establishment in the other country, in which case, Article VII (Business Profits) of the Treaty would apply to allow such guarantee fees to be taxed by the source country. In this regard, the Protocol will apply to guarantee fees paid or credited on or after February 1, 2009.

Extension of Treaty Benefits to LLCs and other Fiscally Transparent Entities

The Protocol provides relief from the long-standing position of the Canada Revenue Agency that a U.S. limited liability company (LLC) that is treated as a fiscally transparent entity for U.S. federal income tax purposes is not a resident of the United States for purposes of the Treaty. As a result, Canada had denied Treaty benefits to LLCs. The Protocol addresses the problem for Americans investing in Canada via U.S. LLCs by extending Treaty benefits to the income, profits or gains derived by U.S. residents on payments made to a fiscally transparent entity in the United States. A "fiscally transparent entity" would include partnerships, U.S. grantor trusts and entities such as LLCs which are treated as partnerships for U.S. federal income tax purposes (in the case of an LLC having more than one (1) member).

As a fiscally transparent entity, the LLC itself is not subject to U.S. federal tax. Prior to the Protocol taking effect, payments made by Canadian residents to a U.S. LLC such as interest, dividends, royalties and management fees, were subject to a 25% Canadian withholding tax. Also, an LLC that disposed of "taxable Canadian property" was not entitled to any capital gains exemption that might otherwise be available to U.S. residents under the Treaty. The Protocol remedies this problem for LLCs and other fiscally transparent entities effective on February 1, 2009, in the case of payments subject to withholding (e.g. interest, royalties and dividends). In the case of capital gains and business profits derived from a permanent establishment by an LLC, the amendments in the Protocol take effect for taxable years commencing after 2008.

Dividends Earned Through Flow-Through Entities

The Protocol contains a relieving rule applicable in the case of shares of a Canadian corporation that are indirectly held by a U.S. corporation through an intermediary U.S. partnership or LLC. Under the Treaty, dividends paid to a corporation which owns at least 10% of the voting stock of the dividend payor will be subject to a withholding tax rate of 5%, instead of the usual 15% rate under the Treaty. Under the Protocol, for purposes of determining whether the 10% ownership requirement is met, a new "look-through" rule 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 (so long as the entity is not a resident of the Contracting State of which the company paying the dividends is a resident). In addition, this look-through provision is only applicable to corporate members of a flow-through entity. This amendment is effective with respect to dividends paid on or after February 1, 2009.

ULCs – Denial of Treaty Benefits

Certain so-called "hybrid" entities such as unlimited liability companies (ULCs) will no longer be able to claim the benefits of the Treaty. This was an unexpected provision contained in the Protocol and will potentially negatively impact many U.S. investors who have formed a ULC in Canada (e.g. Nova Scotia, Alberta, British Columbia ULCs) to carry on business in Canada. Prior to the Protocol, the payment of dividends by a ULC to a U.S. parent corporation would be subject to Canadian withholding tax at a 5% rate and the payment of interest by the ULC to its U.S. parent would be subject to a 10% Canadian withholding tax. (This assumes that the U.S. parent corporation was not an LLC.) As a result of the Protocol, Canadian withholding tax will apply at a 25% rate on the payment of dividends and interest by the ULC to U.S. residents.

These rules come into effect on January 1, 2010. As a result of the pending denial of Treaty benefits in relation to ULCs, it will be necessary to revisit and potentially restructure the ownership in an appropriate manner in order to achieve a more tax-efficient structure and to circumvent the denial of Treaty benefits for ULCs.

Permanent Establishment for Service Providers

The Protocol introduces a new element to the definition of "permanent establishment" (PE) in the Treaty which deals with service providers. Under the expanded definition of PE, the activities of cross-border services providers will, in certain circumstances, constitute a PE. This will result in

the business profits of the service provider being subject to taxation in the source country, even though the service provider does not operate from a "fixed place of business" in the jurisdiction.

Under the expanded definition of PE in the Protocol, a service provider will be deemed to have a PE in the other country if it provides services in the other country and:

- the services are performed in the other country by an individual who is present in the other country for a cumulative total of 183 days or more in any 12-month period, and during that 12-month period, more than 50% of the gross active business revenue consists of income derived from the services performed in the other country by the individual; or
- the services are provided in the other country for an aggregate of 183 days or more in any 12-month period with respect to the same or connected project for customers resident in, or PEs situated in, that other country.

The expanded definition of PE comes into effect for the third taxation year of an enterprise that ends after December 15, 2008. It is expected that this provision will have a major impact on many business that provide cross-border services. There may be a need to make some substantial logistical and other changes under which services are provided with a view to avoiding the creation of a PE in the other country which would subject the business profits to taxation in that other country.

Limitation on Benefits

The Protocol contains a comprehensive limitation on benefits ("LOB") article which will give Canada the ability to protect against so-called "treaty shopping". Previously, the LOB provision in the Treaty only applied for the benefit of the United States. Under the amended LOB provision in the Protocol, the benefits of the Treaty will only be available to residents of Canada or the United States that also satisfy certain other tests, failing which the benefits of the Treaty (e.g. reduced rate of withholding tax on dividends) will be denied.

The amendments to the LOB article under the Protocol will be applicable on or after February 1, 2009, in respect of taxes withheld at source. For all other income tax purposes, the LOB amendments will apply to taxation years that begin after December 31, 2008.

Stock Option Benefit Apportionment Rules

In order to eliminate double-taxation, the Protocol contains a new apportionment rule for taxing employee stock option benefits when an employee is granted stock options as an employee in one country and exercises the option in the other country while employed by the same employer (or a related employer). In general, the stock option benefit will 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). This apportionment rule came into effect on December 15, 2008.

This Bulletin is a general overview and cannot be regarded as legal advice. Readers are urged to consult a qualified lawyer before making any decisions or taking action based on this material alone.

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