

Canada and the U.S. sign treaty protocol

Tax September 24, 2007

On Friday, September 21, 2007, Canada and the United States signed a long overdue update to the 1980 Tax Treaty. The Protocol includes some measures that were originally announced in the March 19, 2007 federal budget, most notably, the elimination of withholding tax on cross border interest payments. Other measures include:

- The extension of treaty benefits to limited liability companies;
- The extension of the 5% withholding tax to dividends paid to certain partnerships of US corporations;
- Measures to ensure that there is no double taxation on an individual's pre-emigration and post-immigration gains;
- Measures to give mutual tax recognition to pension contributions;
- The ability for taxpayers to require that certain key double tax issues, such as transfer pricing, be settled through binding arbitration; and
- Clarification regarding the taxation of the employment benefit that arises on the exercise of stock options, or on the disposition of the related security.

Even though the Protocol has been signed, it still has to be ratified in the House of Commons in Canada and in the United States Senate. For Canada, this means making the Protocol a part of Canadian law, by enacting a statute to that effect. Since the senate foreign relations committee meets relatively infrequently, the ratification process in the U.S. could take even longer. Therefore, the prospect for ratification before year end seems unlikely. Then, it is generally 60 to 90 days before the Protocol enters into force.

Many of the revised treaty provisions are effective on the later of ratification and January 1, 2008. Several provisions have other effective dates.

The following is a summary of the key changes in the Protocol.

Withholding tax on cross border interest payments

Under the current rules, the source country (the country where the payor resides) may levy a 10% withholding tax on interest payments.

Under the Protocol, once the changes are fully phased-in, cross-border interest payments will no longer be subject to withholding tax by the source country. This change will reduce the cost of cross-border

financing, have a positive effect on investment, reduce the legal complexity of borrowing transactions, and support the competitiveness of Canada's multinational enterprises.

For interest paid between unrelated (arm's length) persons, the elimination of withholding tax on interest will take effect on or after the first day of the second month that begins after the date on which the Protocol enters into force (therefore, no earlier than March 1, 2008). For related party (non-arm's length) interest payments, the withholding rate will be reduced over a three year period, as follows:

- 10% until the rate reduction between unrelated persons takes effect;
- 7% for interest paid for the remainder of calendar 2008;
- 4% for interest paid in calendar 2009; and
- Nil for interest paid after 2009.

Although not part of the Treaty Protocol, the 2007 federal budget proposed that as of the effective date of the withholding tax exemption for unrelated party debt, the Canadian tax rules would be amended to unilaterally extend the withholding tax exemption to arm's-length debt with all non-resident lenders.

The extension of treaty benefits to fiscally transparent entities (including Limited Liability Companies (LLCs) and other hybrid entities)

Under the current rules, the Treaty does not deal specifically with fiscally transparent entities, such as partnerships. Particularly troublesome have been hybrid entities: entities that are treated as

corporations under the law of one country, but as partnerships (or "pass-through vehicles") in the other country.

The Protocol provides that treaty benefits will be extended to U.S. residents investing in Canada through certain fiscally transparent entities, including certain hybrids. For example, assume that a U.S. investor uses an LLC to invest in Canada. The LLC, which Canada views as a corporation, but is a flow-through vehicle in the U.S., earns Canadian-source investment income. Provided the U.S. investors are taxed in the U.S. on the income in the same way as if they had earned it directly, Canada will also treat the income as having been paid to the U.S. resident for the purposes of determining access to Treaty protection. The reduced withholding tax rates to which the U.S. investor would have been entitled under the tax treaty had the income been received directly, will now apply.

This revision eliminates a long-standing complaint by U.S. residents that income and profits generated through LLCs are not being taxed fairly in Canada.

The effective date of this revision will depend on the type of income and the date on which the Protocol enters into force.

The Protocol also effectively embeds in the treaty, rules that are already present in the U.S. domestic law, denying treaty benefits where an investor receives income through a hybrid entity that is not resident in the investor's country of residence or through a "reverse-hybrid" entity that is treated as resident in the source country. These rules will take effect no earlier than January 1, 2010.

It is interesting to note that, while the adverse results for a U.S. investor investing in Canada through an LLC appear to have been resolved, potential adverse results for a Canadian investor who invests in the United States through an LLC have not been ameliorated

Tax treatment of dividends

The current rules provide that the rate of withholding tax on dividends is 5% where the recipient is a company that owns directly at least 10% of the voting stock of the company paying the dividends, and 15% in all other cases.

Under the Protocol, in keeping with the new rules regarding the treatment of fiscally transparent entities, the 5% rate will be extended to dividends to a partnership, where at least 10% of the voting stock of a Canadian corporation is held by a U.S. corporation through the partnership.

Taxpayer migration – protection against double taxation

Under the current rules, where an individual ceases to be resident in one country and becomes resident in the other, the tax treaty allows each country to tax its residents on all of their capital gains. No provision is made for the possibility that a country may already have taxed emigrants on the pre-departure gain (as Canada does).

Under the Protocol, where an individual is deemed to dispose of property before becoming a resident of the other country, the individual can elect to have a “basis bump” in the new country of residence.

For example, an emigrant from Canada to the U.S. owns shares that cost \$1,000 and are worth \$10,000. Canada treats the

emigrant as having sold the shares for \$10,000, realizing a \$9,000 capital gain (\$4,500 taxable capital gain). The emigrant can choose to be treated for U.S. tax purposes as having realized that \$9,000 gain before becoming resident in the U.S. The U.S. can tax any future gain over the \$10,000 value of the shares, but will not tax any of the gain that accrued while the individual was resident in Canada.

This will prevent the double taxation of pre-migration gains. This amendment will apply to emigrations that took place after September 17, 2000.

Pensions and other registered plans

Under the current rules, where an individual resides in one country, but works in the other country, there is no assurance that pension contributions (or any of certain other employment-related retirement arrangements) can be deducted for tax purposes. Also, the treaty does not provide for the situation where individuals move from one country to the other on a short-term work assignment, but continue to contribute to a plan or arrangement in the original country of residence.

Under the Protocol, provided certain conditions are met, taxpayers will be allowed to deduct contributions in three limited circumstances: (1) cross-border commuters may deduct, for residence country tax purposes, the contributions they make to a plan or arrangement in the country where they work; (2) those who move for work and meet certain conditions can deduct, for source country tax purposes, their contributions to a plan or arrangement in the other country, for up to five years and (3) for U.S. citizens resident

in Canada, the U.S. will permit deductions to Canadian pension plans if deductible under Canadian law and within U.S. contribution limits.

For example, a resident of Canada is employed in the U.S., and contributes to an employer-sponsored pension plan there. The employee's contributions to the plan (up to the employee's remaining RRSP deduction room) will be deductible for Canadian tax purposes.

This amendment will apply for taxation years that begin after the calendar year in which the Protocol enters into force. However, if ratification is completed in 2007, the rule will apply for taxation years that begin in 2008.

Mandatory binding arbitration

Under the current rules, the tax treaty has a general rule that allows the revenue authorities to agree in cases where the treaty does not resolve an issue between them. However, this is a voluntary arbitration procedure. If the revenue authorities do not resolve the dispute, there is no further mechanism to resolve the dispute. This means that taxpayers cannot be assured that their double taxation problems will be resolved.

Under the Protocol, subject to certain conditions, taxpayers can elect to compel the authorities to refer their dispute to binding arbitration.

One of the more common situations that would result in such a binding arbitration process would be where the taxpayer has been levied a transfer pricing adjustment in only one of the countries, effectively subjecting the taxpayer to double taxation.

For example, a U.S. company sells goods to its Canadian parent company for a certain price. A U.S. transfer pricing audit determines that a higher price should have applied, and assesses more income in the hands of the subsidiary. However, Canadian authorities do not agree with the higher transfer price and decline to increase the Canadian company's cost of the goods. The two tax authorities cannot reach agreement. Subject to certain conditions, the companies can choose to require the tax authorities to put the matter to binding arbitration.

This amendment will apply to cases that are, when the Protocol enters into force, already under consideration under the treaty's mutual agreement procedure, as well as cases that subsequently come under consideration.

Employee stock options

Under the current rules, where an employee is granted a stock option while employed in one country, and then goes to work for the same or a related employer in the other country before exercising or disposing of the option (or share), there are no specific rules to provide for the apportionment of the stock option benefit between the two countries.

Under the Protocol, the stock option benefit will generally be considered to have been derived in a country to the extent that the individual's principal place of employment was in that country during the time between the granting of the option and its exercise (or the disposition of the share).

For example, an employee of a U.S. company is granted a stock option on

January 1, 2009. On January 1, 2010, the employee relocates to the company's Canadian subsidiary. On December 31, 2011, the employee disposes of the option, giving rise to an income inclusion. Unless the revenue authorities agree that the circumstances warrant departing from the usual rule, one third of the income will be treated as having arisen in the U.S., and two thirds in Canada.

This amendment will enter into force on the same date as the Protocol.

Employment income

For purposes of Article XV(2)(b), the reference to 183 days now refers to 183 days in any 12 month period, rather than 183 days in the calendar year. Therefore, it will be easier to fall offside the exemption from taxation in the other country.

Dual resident corporations

Under the current treaty, it is possible that a U.S. corporation could be continued into Canada without a corresponding discontinuance under U.S. corporate law. Such a corporation would be resident in Canada under the current provisions of the Treaty but would remain resident in the United States for purposes of U.S. tax law.

The Protocol provides that a company incorporated in one country and continued into the other will remain a resident of the first country, unless that country's corporate law no longer treats it as such.

This provision will apply with respect to continuances that take place after September 17, 2000.

Definition of permanent establishment

The definition of a permanent establishment in the Treaty has been expanded to cover certain situations where a resident of one country provides services in the other country. This amendment appears to be in response to the Federal Court of Appeal's decision in *Dudney*. In this case, a U.S. resident taxpayer earned income by performing certain services in Canada as an independent contractor. Such work required the taxpayer to be at the client's premises training its employees with respect to a new technology. The Federal Court of Appeal concluded that the income derived by the taxpayer from the contract was not subject to Canadian tax since the taxpayer did not have a "fixed base regularly available to him in that other State". It was not a location where the independent contractor carried on his or her business.

The updated Protocol provides that services will be deemed to be provided through a permanent establishment where:

- (a) those services are performed by an individual who is present in a country for a period or periods aggregating 183 days or more in any twelve-month period, and
- (b) during that period or periods, more than 50% of the gross business revenues consists of income derived from the services performed by the individual in that country.

There is also a new deeming rule that may apply where services are performed in respect of connected projects. The end result is that an individual may have a permanent establishment in a country without having a fixed place of business or an agent in that country.

This amendment will generally be effective for the third tax year that ends after the Protocol enters into force.

Limitation of benefits

A few modifications have been made to the Limitation of Benefits (LOB) article in the Treaty. The key change is that the LOB provisions are now reciprocal. Previously, they applied only to potentially limit the availability of the treaty to a Canadian person claiming protection from U.S. tax under the treaty. The LOB provisions now also apply to U.S. persons claiming protection from Canadian tax under the treaty.

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