



Advisor Alert

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Canada & U.S. Sign Fifth Protocol to the U.S.-Canada Income Tax Convention

On September 21, 2007, Canadian Finance Minister Jim Flaherty and U.S. Treasury Secretary Henry Paulson signed the Fifth Protocol (the Protocol) to the Canada-United States Tax Convention (the Treaty) in Chelsea, Quebec. The signing concludes almost 10 years of negotiations on updating the Treaty and represents the most comprehensive treaty protocol, supplemented by Diplomatic Notes, the U.S. has signed.

The Protocol delivers significant benefits to Canadian and U.S. individuals and businesses:

- ✓ Eliminates source-country withholding tax on cross-border interest payments
- ✓ Extends treaty benefits to limited liability companies
- ✓ Clarifies how stock options are taxed
- ✓ Gives mutual tax recognition of pension contributions
- ✓ Ensures there is no double taxation of emigrants' gain
- ✓ Implements many technical improvements and updates

For U.S. individuals and businesses, though, the Protocol's treatment of Canadian unlimited liability companies (ULC) might ameliorate the other benefits afforded by the agreement if ULCs were used as part of a cross-border tax strategy.

The Protocol calls for mandatory

arbitration to resolve double taxation disputes. Also, significant from a Canadian perspective are provisions that extend the limitation on benefits, *i.e.*, the ability to claim treaty benefits, to investments into Canada.

The Protocol now must be ratified in Canada's House of Commons and in the U.S. Senate. It will enter into force once the Protocol is ratified or on January 1, 2008, whichever occurs later. The two countries share the world's largest bilateral trade relationship, with more than \$530 billion in annual exports, and the Treaty has significant implications for the flow of capital and economic resources between the U.S. and Canada.

Changes related to withholding tax will be effective with respect to payments or credits made on or after the first day of the second month beginning after entry into force. Other changes will generally be effective for taxable years that begin after the calendar year in which the Protocol enters into force. However, it is important to note that a number of provisions have different effective dates.

Withholding tax on interest/guarantee fees

The current treaty allows for a 10% withholding rate on cross-border interest payments. The new provision applies to unrelated-party payments as of the second month after the Protocol enters into force.

For related-party interest payments, the withholding tax will be eliminated

gradually. The withholding rate is reduced to 7% in the first year after entry into force, then to 4% in the following year and, finally, to 0% in the third year. Guarantee fees will no longer be subject to withholding tax.

The Protocol will not affect the rate of withholding on dividends.

LLCs & hybrid entities

Before this agreement, the Canada Revenue Agency (CRA) did not extend the Treaty's benefits to U.S. LLCs treated as flow-throughs. CRA viewed LLCs as corporations not subject to tax in the U.S. Although all tax liability flows through to LLCs members, CRA did not treat LLCs as residents for purposes of applying the U.S.-Canada Treaty; thus, Canada treated such entities as ineligible for Treaty benefits, such as reduced withholding tax rates and permanent establishment thresholds for taxation.

Under the Protocol, LLC members that are U.S. residents will now be eligible to claim Treaty benefits for taxable years beginning in or after 2008. This will be a very helpful change. Under the new Protocol, Canada generally will treat Canadian-source income earned by a flow-through U.S. LLC as having been earned by its members, and the reduced withholding rates the Treaty provides will apply.



However, if the LLC's income is not taxed directly in the hands of its investors, Canada will not treat the income as having been earned by a U.S. resident, and Treaty benefits will not apply. The Protocol does not affect the favorable treatment of S corporations as nonflow-throughs under Canadian domestic rules.

Article 2 of the Protocol contains provisions that can deny Treaty benefits when fiscally transparent entities are involved, *e.g.*, Canadian ULCs. Article 2's language is inordinately complex, so we have included reference designations applicable to a U.S. person. "An amount of income, profit or gain shall be considered not to be paid to or derived by a person who is a resident of a contracting state, *e.g.*, the U.S. person cannot claim the benefits of the Treaty, where:

- a) The person is considered under the taxation law of the other contracting state, *e.g.*, Canada, to have derived the amount through an entity that is not a resident of the first-mentioned state, *e.g.*, U.S., but by reason of the entity not being treated as fiscally transparent under the laws of that state, *e.g.*, U.S. reverse hybrid, the treatment of the amount under the taxation law of that state, *e.g.*, U.S., is not the same as its treatment would be if that amount had been derived directly by that person; or
- b) The person is considered under the taxation law of the other contracting state, *e.g.*, U.S., to have received the amount from an entity that is a resident of that other state, *e.g.*, Canada, but by reason of the entity being treated as fiscally transparent under the laws of the first-mentioned state, *e.g.*, U.S., the treatment of the amount under the taxation law of that state, *e.g.*, U.S., is not the same as its treatment would be if that entity were not treated as fiscally transparent under the laws of that state, *i.e.*, regardless of the fact that Canada treats the U.S. person as receiving a payment from a Canadian company."

The second rule means that, once in force, dividends and interest paid to a U.S. person by a Canadian ULC (such as Nova Scotia or Alberta ULC, which is treated as a flow-through for U.S. tax purposes) will not be entitled to a reduced rate of withholding under the Treaty; rather, such payments will be subject to 25% withholding under Canadian domestic law.

This provision could significantly affect countless U.S. investments into Canada that have been structured to use ULC planning strategies. These rules are not effective until at least 2010.

Under a very common situation, assume a ULC was set up by individual shareholders who wanted to claim a foreign tax credit for the taxes paid to Canada by the ULC. Under the Protocol, the foreign tax credit would still be available to individual shareholders, but, instead of being subject to 15% withholding, distributions would be subject to 25% withholding. Interest paid by the ULC to U.S. persons would also be subject to 25% withholding, rather than the reduced rate provided by the Protocol.

This provision will likely be the Protocol's most controversial. When the check-the-box regulations were originally proposed in the U.S., many taxpayers urged the IRS to exclude Nova Scotia ULCs from its list of "per se" corporations. In its final regulations, the IRS agreed to permit a check-the-box election for these entities.

As a result, numerous cross-border tax strategies were implemented utilizing ULCs. If the Protocol is implemented in its present form, all of these structures will need to be re-evaluated, and U.S. businesses and individuals who employed these strategies will likely be subject to a higher effective tax rate with respect to their Canadian operations.

Dual resident corporations

The Protocol amends the Treaty's "tie-breaker" rule to provide that a company resident in both countries that was created or organized in one country, *i.e.*, U.S., will remain a resident of the U.S.—notwithstanding that it is later continued

to or redomiciled under Canadian rules. Such a corporation will not be entitled to any benefits under the Treaty except to the extent agreed on by the competent authorities of the two countries. It is unusual, but the provision would be retroactive to 2000.

Dividends received by a partnership

Under the Treaty, the rate of withholding tax on dividends paid by a company, for example, Canadian, to a resident of the other state, *e.g.*, the U.S., is reduced to 5% provided the recipient is a company that owns a minimum of 10% of the voting stock of the payor corporation and to 15% in all other cases.

CRA has taken the position that, where a U.S. corporation is a member of a partnership that owns shares of a Canadian corporation, the rate of withholding tax cannot be reduced to 5%, even if the U.S. corporation owns—indirectly through the partnership—more than 10% of the voting stock of the Canadian corporation.

The Protocol will eliminate the need for the U.S. corporation to hold direct voting shares in the Canadian corporation in order to obtain the lower Treaty rate. Nevertheless, the partnership/partners of U.S. and Canadian partnerships will continue to bear the compliance burden of substantiating their indirect ownership.

Attribution of profits to permanent establishments

The Diplomatic Notes to the Protocol contain guidance to the effect the governments apparently are to incorporate the new "Authorized OECD Approach" to profit attribution. This provision is important because the IRS has previously taken the position that the OECD approach will not govern its interpretation of U.S. treaty business profits.

Changes affecting the "permanent establishment" rules (see below) mean it will be easier for Canada to argue a U.S. business has a taxable presence in Canada, and, under the Protocol, Canada will have significantly more flexibility in de-

cluding what profits are attributable to Canadian operations.

Provision for limitation on benefits

The Protocol contains a new limitation-on-benefits provision that, under certain situations, denies the benefits of the Treaty to a resident of a contracting state. This marks a significant change for Canada, which generally has not included a limitation-of-benefits provision in its treaties. Until now, Canada has relied on its general domestic anti-avoidance rule to manage treaty shopping.

Mandatory arbitration

The Protocol calls for mandatory arbitration on certain issues to resolve double taxation disputes: If disputes cannot be resolved by revenue authorities, taxpayers may elect to compel them to refer the matter to binding arbitration where one country's is selected.

Under U.S. foreign tax credit rules, such arbitration may be required to claim the benefits of the credit. No U.S. tax treaties currently permit binding arbitration, though similar provisions are in the pending agreements with Belgium and Germany; both are before the Senate Foreign Relations Committee awaiting further action.

Permanent establishment affects certain service providers

The Protocol will treat an enterprise as having a permanent establishment in the other country in two circumstances, notwithstanding most exceptions to the existence of a permanent establishment for income taxes (such as the exception for preparatory or auxiliary activities):

- ✓ Where services are performed in the other country by an individual who is present in the other country not less than 183 days in any 12-month period, and, during that time, more than 50% of the gross active business revenues of the enterprise consist of income derived from the services performed in that other country by that individual.

- ✓ Where services are provided in the other country for an aggregate of at least 183 days in any 12-month period with respect to the same or a connected project for customers who are either residents of the other country or maintain a permanent establishment in that other country, and the services relate to that permanent establishment.

This provision will not apply until the third taxation year that ends after the Protocol comes into force and not before January 1, 2010, in any event.

Employee stock option benefits treatment clarified

The Protocol will deem a stock option benefit to be derived from the country in which the person is principally employed during the time the option is held.

This change is designed to manage situations where an employee is granted an option while a resident of one country, then moves to the other country before the date of exercise. It will apportion the benefit between the two countries for income tax purposes.

An Annex to the Protocol also provides a different apportionment of the benefits can be used where competent authorities of both countries agree the terms of the options should be treated as a transfer of ownership of the securities, *i.e.*, where the options are "in the money" at grant or where the options are not subject to a substantial vesting period.

Individual deemed disposition gain on departure

The Protocol amends the Treaty to remedy a problem that exists under the current law where an individual emigrates from Canada to the U.S. Under Canada's domestic law, when a person emigrates from Canada, the person is deemed to have disposed of property for proceeds equal to their fair market value.

The U.S. does not provide the emigrant a step-up in the tax basis of the property, which often results in double taxation on its subsequent sale. The

Protocol provides when an individual—and not any other type of entity—has been deemed to have alienated property in a taxable transaction in one country (Canada), the individual can elect for tax purposes in the other country (U.S.) to be deemed to have acquired the property at its fair market value as of that date.

Pension contributions

Pension contributions by persons who live in one country, but work or are temporarily assigned to the other country, will be deductible by the employee or the employer in certain situations.

This provision benefits cross-border commuters—individuals residing in one country and working in the other—who contribute to a pension plan (or any of certain other employment-related retirement arrangements) in the country where they work.

The provision also benefits individuals who move from one country to the other on short-term work assignments up to five years, and continue to contribute to a plan or arrangement in the first country. In certain cases, the employer may also benefit. There presently is no rule in respect of contributions, meaning, there is no assurance they may be deducted for tax purposes in the country of employment.

Under the Protocol, provided certain conditions are met, cross-border commuters may deduct, for residence country tax purposes, contributions they make to a plan or arrangement in the country where they work. Similarly, those who move for work and meet certain conditions may deduct, for source-country tax purposes, contributions to a plan or arrangement in the other country, for up to five years.

In both cases, the accruing benefits are not taxable. For example, a U.S. person on assignment in Canada could continue to accrue and contribute to the registered pension plan of his/her U.S. employer and deduct such contributions for Canadian tax purposes.

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