

MNP TAX ALERT

CANADA-US TREATY PROTOCOL – HOW DO THE NEW MEASURES AFFECT YOUR BUSINESS?

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Highlights of the Canada-US Treaty Protocol

On September 21, 2007 the fifth Protocol to the Canada-US Income Tax Convention (the "Treaty") was signed. While the Protocol includes a number of relieving measures that were expected, a number of unanticipated measures have also been introduced. This *Tax Alert* summarizes key measures that may affect cross-border businesses and individuals.

The Protocol must now be ratified in the House of Commons (Canada) and the US Senate. The Protocol will enter into force on the later of January 1, 2008 and the date of ratification by both countries.

HIGHLIGHTS OF THE PROTOCOL:

CORPORATE TAX

- Elimination of withholding taxes on cross-border interest payments;
- Extension of treaty benefits to Limited Liability Companies; and
- Denial of treaty benefits to other hybrid entities - Reverse Hybrids and Unlimited Liability Companies ("ULC's")

PERSONAL TAX

- Mutual tax recognition of pension contributions in cross-border employment situations;
- Clarification on how stock options are taxed in cross-border situations;
- Broadening of the 183 day rule on income from employment for cross-border employees;
- Elimination of double taxation on emigrant gains; and
- Deemed permanent establishment for services business (if threshold test met).

OTHER

- Introduction of a mandatory arbitration process for Canada / US tax authorities to resolve certain issues (transfer pricing, allocation of profits, residency determination and certain royalties);
- Limitation on benefits – abuse and "treaty shopping" provision; and
- Accounting Implications on Protocol changes.

HOW DO THE NEW MEASURES AFFECT YOUR BUSINESS?

- All cross-border structures currently in place that use hybrid entities should be reviewed. While the earliest date for these changes to be effective is January 1, 2010, planning should be done now to mitigate any adverse tax consequences.
- Companies who engage in cross-border transactions may need to assess the impact of the Protocol on their future income tax balances.
- If you have cross-border employees or executives, care must be taken to ensure threshold tests are understood and closely monitored as there are a number of new measures that broaden the taxability of income in the other country.
- If you are a service provider or a consultant who provides services (for one project or connected projects) for more than 183 days in any 12 month period across the border, you may be subject to tax (or additional compliance requirements).
- If you are making payments to US recipients, additional documentation may be required to support the eligibility for treaty benefits to ensure for example, the correct amount of withholding tax has been remitted.

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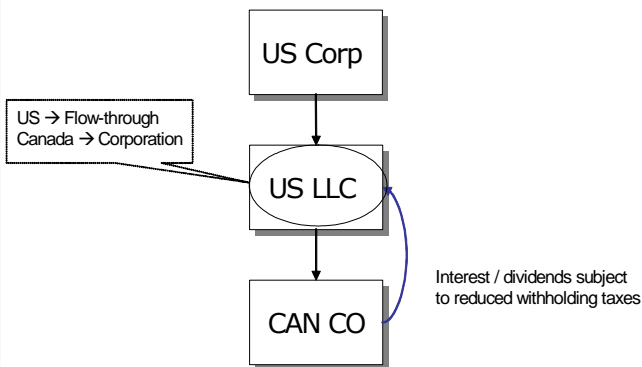
A. CORPORATE TAX

ELIMINATION OF WITHHOLDING TAXES ON CROSS-BORDER INTEREST PAYMENTS

Situation: A resident of Canada or the US pays interest on a loan / debt to a person in the other country.
Protocol: Eliminates the withholding tax (previously 10% under the Treaty) on cross-border non-contingent interest payments (as previously announced in the March 2007 Federal Budget)¹. The Protocol also clarifies that guarantee fees will generally be free of withholding tax.

Effective: Unrelated persons: the second month after the Protocol enters into force. Related persons: Phased-in elimination of the current 10% withholding tax: 7% - first calendar year following entry into force of the Protocol; 4% - second calendar year following entry into force of the Protocol; and 0% - third and subsequent years following entry into force of the Protocol.

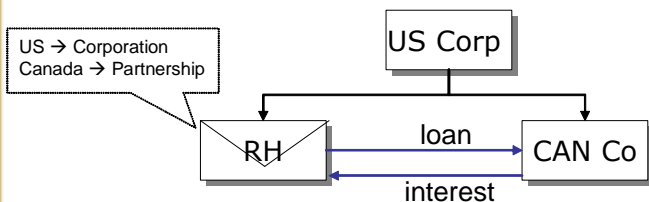
EXTENSION OF TREATY BENEFITS TO LIMITED LIABILITY COMPANIES



- **Situation:** US investor who uses LLC to invest in Canada
- **Protocol:** Income is derived by a resident of the US if derived through an entity that is fiscally transparent in the US (and not a resident of Canada)
- **Result:** US Corp will now be entitled to reduced withholding tax on dividends and interest paid by Can Co.
- **Effective:** taxation years beginning after the calendar year of entry into force. However, if ratification is completed in 2007 the protocol will be effective for taxation years that begin in 2008.

DENIAL OF TREATY BENEFITS TO OTHER HYBRID ENTITIES

i. REVERSE HYBRIDS



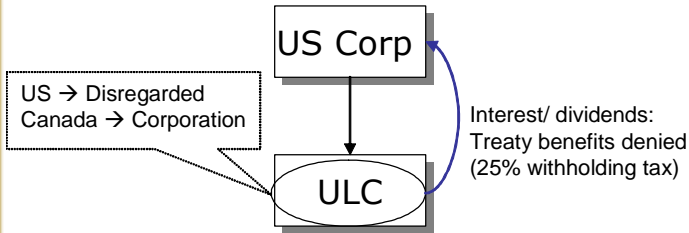
- **Situation:** US investor who finances their Canadian operations through a “reverse hybrid”.
- **Protocol:** Income is not paid to or derived by a resident of the US if derived through an entity that is not fiscally transparent in the US and is not a resident of Canada.
- **Result:** The new rules deny treaty benefits (resulting in 25% withholding tax on interest paid by Can Co to RH).
- **Effective:** Earlier of January 1, 2010 & the first day of the third calendar year that ends after entry into force.

¹ The Department of Finance (Canada) has also released draft legislation that includes provisions to exempt withholding tax on any interest payments made by a Canadian resident to an arm’s length non-resident (regardless of country of residence). The provision should also be effective on the same date that withholding tax on interest paid to unrelated persons is eliminated under the Treaty.

Highlights of the Canada-US Treaty Protocol

DENIAL OF TREATY BENEFITS TO OTHER HYBRID ENTITIES (CON'T)

ii) UNLIMITED LIABILITY COMPANIES (“ULC”)



- Situation: US investor who uses a ULC as their operating entity in Canada (possibly for state tax, start-up loss and foreign tax credit planning purposes)
- Protocol: Income is not paid to or derived by a resident of the US if received from an entity that is fiscally transparent in the US and a resident of Canada.
- Result: Since the interest / dividend payment is disregarded in the US – the new rules deny treaty benefits (resulting in 25% withholding tax on interest paid by ULC to US Corp.)
- Effective: Earlier of January 1, 2010 & the first day of the third calendar year that ends after entry into force.

B. PERSONAL TAX

MUTUAL TAX RECOGNITION OF PENSION CONTRIBUTIONS IN CROSS-BORDER EMPLOYMENT SITUATIONS

Situation: Individuals who live in one country and work in the other while contributing to a pension plan in the country where they work. The Protocol will also apply where an individual moves for a short-term work assignment (up to 5 yrs.) and contributes to a pension plan in the first country.

Protocol: Deduction available for contributions made to a plan or arrangement in the country of work / source country (depending on the situation; limitations apply). Accruing benefits under these plans will not be taxable.

Result: Cross-border employees will be able to deduct (in their country of residence) contributions made to pension plans of their work country. Correspondingly, individuals on short term cross border work assignments will be able to deduct contributions made to their home country’s pension plan.

Effective: taxation years beginning after the calendar year of entry into force. However, if ratification is completed in 2007 the protocol will be effective for taxation years that begin in 2008.

CLARIFICATION ON HOW STOCK OPTIONS ARE TAXED IN CROSS-BORDER SITUATIONS

Situation: Individuals who are granted stock options while employed in one country and then work for the same or related employer in the other country prior to exercising or disposing of the option.

Protocol: New rule requires the apportionment of the stock option benefit to be determined based on the principal place of employment during the period from the date of grant to the date of exercise or disposal of the option.

Result: Ensures that double taxation does not arise on stock option benefits. Issues surrounding the definition of principal place of employment still need to be addressed.

Effective: taxation years beginning after the calendar year of entry into force. However, if ratification is completed in 2007 the protocol will be effective for taxation years that begin in 2008.

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BROADENING OF THE 183 DAY RULE ON INCOME FROM EMPLOYMENT FOR CROSS BORDER EMPLOYEES

Situation: Employees resident in one country and work in the other country for periods greater than 183 days in any 12 month period.

Protocol: The threshold test has been broadened to 183 days in any 12 month period commencing or ending in the taxation year (previously an individual could exempt their employment income from tax in the other country if the 183 days straddled two taxation years).

Result: Employees will be required to track their cross-border business travel very closely to determine taxation of employment income in the other country.

Effective: taxation years beginning after the calendar year of entry into force. However, if ratification is completed in 2007 the protocol will be effective for taxation years that begin in 2008.

NO DOUBLE TAXATION ON PRE-EMIGRATION GAINS ON ACCRUED PROPERTY

Situation: Individuals who cease to be a resident in one country and become resident in another.

Protocol: On ceasing to be a resident of one country, a deemed disposition of property at its fair market value occurs. The Protocol permits the emigrating individual to elect to be treated in the second country as having sold and repurchased the property for fair market value.

Result: no double taxation on gains resulting from a deemed disposition of property.

Effective: Upon ratification this change will be effective after September 17, 2000 (as this change was previously announced in a press release September 18, 2000).

DEEMED PERMANENT ESTABLISHMENT (“PE”) FOR SERVICES BUSINESS

Situation: US businesses that perform services in Canada (that are not in respect of an employment) and vice versa will fall under this provision.

Protocol: A deemed PE will result if the services are performed in the other country for more than 183 days in any 12 month period and during the 183 days, more than 50% of the gross revenues of the enterprise were derived from such services; or the 183 days in any 12 month period threshold is met where the same or connected project is performed for customers who maintain a PE in the other country.

Result: More independent service providers who provide services across the border may be subject to tax in the other country as the period for measuring the 183 day test is a rolling 12 month period (rather than fixed to a specific year). Additional compliance may also be required (payroll registration, withholding and tax return filings).

Effective: Earlier of January 1, 2010 and the first day of the third taxation year of a taxpayer that ends after entry into force.

Highlights of the Canada-US Treaty Protocol

C. OTHER

INTRODUCTION OF A MANDATORY ARBITRATION PROCESS FOR CANADA / US TAX AUTHORITIES TO RESOLVE CERTAIN ISSUES

Situation: Taxpayers who are faced with potential double taxation because treaty rules or negotiations between Canada and the US revenue authorities cannot resolve an issue.

Protocol: Taxpayers will be able to request the tax authorities to refer their dispute to binding arbitration. (Previously there was no mechanism in place to resolve insoluble issues).

Result: Issues relating to residency determination, attribution of profits to a permanent establishment, transfer pricing, and certain issues relating to royalties will be available for arbitration.

Effective: once the Protocol enters into force, any case currently in the system can apply this provision.

LIMITATION OF BENEFITS (“LOB”)

Situation: US residents seeking treaty benefits from Canada will be required to meet certain tests.

Protocol: The extension of the LOB provision to Canada is aimed at minimizing abuse of the Treaty, including “treaty shopping,” by ensuring that benefits under the Treaty are available to “qualifying” Canadian and US residents or otherwise by meeting certain tests.

Result: New (and more onerous) compliance burden (for e.g. Canadians making payments to US recipients). It is anticipated that documentation will need to be obtained to support the eligibility for treaty benefits (although Canada Revenue Agency has yet to release its guidelines and procedures).

Effective: Dependent on taxes involved: Withholding taxes – the LOB applies for amounts paid or credited on or after the first day of the second month that begins after the Protocol enters into force. All other taxes – the LOB is effective for taxable years beginning after the calendar year in which the Protocol enters into force. However, if ratification is completed in 2007 the protocol will be effective for taxation years that begin in 2008.

ACCOUNTING IMPLICATIONS ON PROTOCOL CHANGES

Situation: Companies that engage in cross-border transactions and who are impacted by the changes to the Protocol.

Result: The changes included in the Protocol are not considered substantively enacted for Canadian GAAP purposes (or enacted for US GAAP) until ratification. Therefore, companies will need to assess the impact of the Protocol on their future income tax balances. Further, the introduction of the new LOB article may also give rise to unrecorded withholding tax liabilities (for e.g. failure to withhold penalties, etc.)