
Foreign Income & Taxpayers

Commentary on the Canada-U.S. Tax Treaty's Fifth Protocol

By Joseph Sardella, CA, CPA, MSCM LLP, Toronto, Canada, Member, AICPA Tax Strategy Patent Task Force

On September 21, 2007, after ten long years of on-and-off negotiations, the U.S. Secretary of the Treasury and the Canadian Minister of Finance signed an important tax agreement updating certain provisions of the Canada-U.S. Tax Treaty. This update, the Fifth Protocol, was meant to rectify the “drag” that outdated tax rules have had on capital mobility and also to curb cross-border tax arbitrage.

Somewhat surprisingly, the protocol has drawn mixed reactions. Although acknowledging it as long overdue, Canadian tax practitioners have criticized certain provisions as having been poorly drafted and lacking the breadth and flexibility to evolve with increasingly sophisticated financial structures.

The protocol’s scope is ambitious. The provisions are meant to:

- Eliminate withholding taxes on cross-border interest payments;
- Extend treaty benefits to treaty members of limited liability companies (LLCs);
- Restrict the ability of hybrid entities to claim treaty benefits;
- Redefine certain permanent establishment thresholds;
- Permit taxpayers to require that certain key double tax issues be settled through arbitration;
- Grant mutual recognition of pension contributions; and
- Clarify the taxation of stock options arising from cross-border employment.

Canada has also now finally adopted a “limitation of benefits” rule bringing it in line with other U.S. treaty partners.

The protocol will come into force on the day that both Canada’s House of Commons and the U.S. Senate complete their respective constitutional and procedural requirements and have exchanged instruments of ratification. (The Canadian government passed legislation implementing the protocol in December 2007 (Bill S-2, An Act to Amend the Canada-United States Tax Convention Act, 1984); the protocol now awaits ratification by the U.S. Senate.) Certain provisions will apply retroactively, while others will be delayed until the protocol is ratified.

Withholding Taxes

Interest: Withholding taxes on interest paid to nonresidents of Canada for indebtedness between parties dealing with each other on an arm's-length basis (i.e., unrelated) will be totally eliminated beginning January 1, 2008, provided the interest is not participating interest (i.e., tied to profit performance).

Withholding taxes on interest paid on related-party indebtedness will be phased out over a three-year period. On the first day of the second month after the protocol is ratified (likely in 2008), withholding tax on interest paid on related-party loans will be reduced to 7%. The rate will drop to 4% the following year and will be totally eliminated in the subsequent year.

Under the Canadian tax rules, interest is deductible on an accrual basis. The deferral of the actual payment of interest to a subsequent tax year with a lower withholding tax rate can increase cashflow.

On November 13, 2007, in an event unrelated to the protocol, the Canadian government introduced an amendment to the Canadian domestic income tax laws to eliminate withholding tax on all interest paid to nonresidents of Canada for arm's-length indebtedness (Bill C-28, Budget and Economic Statement Implementation Act, 2007). The decision to extend this treaty benefit to all of Canada's treaty partners by amending domestic tax law within a matter of weeks after the U.S. protocol raises the question of why it took so long to accomplish the same result with Canada's largest trading partner. Arguably, it may be perceived as devaluing the formality of the treaty negotiation process.

Dividends: Although the United States has been negotiating reduced dividend withholding tax rates with other countries (e.g., the United Kingdom), the United States and Canada have agreed not to make any changes to the dividend withholding tax rates, although there has been some moderate tweaking of nagging definitional issues. Accordingly, the 15% rate (reduced to 5% when the recipient company owns 10% or more of the paying company's voting stock) will remain in effect.

Under the protocol's lookthrough rules, a change clarifies that the reduced 5% withholding rate on dividends will apply to dividends paid by a Canadian corporation when the shares of the Canadian corporation are owned by a U.S. company through a U.S. general partnership or LLC. Prior to the protocol, when a U.S. corporation owned a Canadian company through a U.S. general partnership, dividends paid by the Canadian company (which would ultimately end up in the U.S. corporation) were not eligible for the reduced 5% dividend treaty withholding tax rate because the U.S. corporation was not considered to "own" the shares of the Canadian company held by the U.S. general partnership. Under the protocol, the U.S. corporation will be deemed to own the shares of the Canadian company.

To establish whether the requisite 10% ownership test is met for this reduced withholding tax rate, the lookthrough rule is available only to a U.S. resident that is a corporation and that has an interest in a fiscally transparent entity.

Example 1: *US Corp.* is a resident of the United States and a 50% member of a U.S. general partnership, which is an 80% shareholder of *C*, a Canadian corporation. *US* will be deemed to own 40% (50% of 80%) of *C*, thus qualifying *US* for the 5% treaty dividend withholding rate (since the ownership of *C* is greater than 10%).

Distributions from U.S.-based real estate investment trusts (REITs) will be covered by the dividends article of the treaty. REIT distributions to individuals resident in Canada will be subject to a 15% withholding tax if the ownership in the REIT 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 the domestic U.S. withholding tax rate of 30%.

Limited Liability Companies

LLCs are treated as passthrough vehicles for U.S. tax purposes (assuming no check-the-box election has been made). The longstanding position of the Canada Revenue Agency (CRA) was that LLCs were not “resident” in the United States because they did not pay tax there. Accordingly, LLCs were not entitled to the benefits of the Canada-U.S. tax treaty, so passive payments made by Canadian entities were subject to a 25% withholding tax and no permanent establishment protection was available. Under the new protocol, the CRA will “look through” LLCs and effectively extend treaty benefits to a U.S. LLC, provided the LLC member is a resident of the United States and would have been taxable on the receipt of the foreign income in the same manner as the LLC.

Example 2: *R*, a U.S. LLC, is owned 60% by a U.S. person and 40% by a Mexican company. Only 60% of *R*'s Canadian source income will be entitled to Canadian treaty protection. The portion owned by the Mexican entity cannot rely on the Canadian treaty provisions, even though Mexico has a treaty with Canada.

Hybrid Entities

Without a doubt the most controversial protocol provisions will deny treaty benefits when income, profits, or gains are derived through hybrid entities and from hybrid entities. The provision for items derived through hybrid entities would apply to inbound Canadian financing structures such as synthetic nonresident-owned corporations (NROs), whereas the provision for items derived from hybrid entities would apply when a U.S. parent company derives income from a foreign entity that is disregarded for U.S. tax purposes, such as a Canadian unlimited liability company (ULC) (a disregarded entity under Regs. Sec. 301.7701-2(b)(8)(ii)(A)(1)). The attack on hybrid structures would also affect U.S. inbound financing transactions such as the U.S. “tower” structures used by Canadian companies to finance subsidiaries in the United States, resulting in increased costs of using such financing arrangements.

Example 3: Prior to the Fifth Protocol, if a U.S. corporation owned 100% of the shares of *N*, a Canadian Nova Scotia unlimited liability company (NSULC), any dividends paid by *N* to its U.S. parent would be eligible for a treaty-reduced 5% withholding rate. Under the protocol, the

dividends paid by *N* would be subject to a 25% withholding tax rate with no treaty reduction available to *N* because its tax treatment in Canada (i.e., considered a corporation) is not the same as its U.S. tax treatment (i.e., considered a disregarded or flowthrough entity).

Example 4: *US*, a U.S. corporation, owns 100% of the shares of *C*, a Canadian corporation. *US* and one of its U.S. subsidiaries are partners in *P*, a Canadian partnership. A check-the-box election to treat *P* as a corporation for U.S. purposes is filed, creating a reverse hybrid. *US* borrows money from a U.S. bank, which it transfers to *P*. In turn, *P* loans the funds to *C*. Under the current rules, the CRA would look through *P* so that interest paid by the debtor *C* to the creditor *P* would be entitled to a treaty-reduced withholding tax rate of 10% (or less as the phaseout kicks in).

This structure results in a double deduction of interest, namely, once in the United States by *US* as interest is owed to the U.S. bank and again in Canada by the Canadian corporate debtor. Although *P* (the reverse hybrid) would by definition be considered a controlled foreign corporation (CFC) for U.S. tax purposes, its interest income would not be subject to current U.S. taxation as subpart F income to *US* due to the same-country exception (Sec. 864(d)(7)). Under the protocol, the interest payments noted above would be denied treaty benefits and subject to a 25% withholding tax at source.

Example 5: In the classic U.S. inbound financing structure known as the tower structure, *C*, a Canadian corporation, owns 100% of *W*, a U.S. operating C corporation. *C* is also a partner in *L*, a U.S. limited partnership (LP), which checks the box to be treated as a corporation for U.S. tax purposes (a domestic reverse hybrid). *L* is the shareholder in *N*, a Canadian NSULC, which checks the box to be disregarded for U.S. tax purposes (a hybrid). *N* holds a 100% interest in *X*, a U.S. LLC (a single-member LLC disregarded for U.S. tax purposes). *L* borrows from a U.S. bank and capitalizes *N* with the proper combination of debt to equity so as to fit within the safe harbor of Sec. 163(j). *N* in turn uses those funds to capitalize *X*, which in turn loans the funds to *W*.

For U.S. tax purposes, interest paid by *W* would be treated as interest expense by *W* and as interest income by *L*, the U.S. domestic reverse hybrid. This interest income would be offset by the interest expense paid by the reverse hybrid to the U.S. bank. After paying other administrative expenses, *L* would be left with a sliver of income subject to U.S. taxation. For Canadian tax purposes, on its Canadian tax return, *C*, the Canadian parent, would be able to deduct the interest *L* paid to the bank. *N* and *X* are considered corporate entities for Canadian tax purposes, thereby “plugging up” the interest income in these entities.

To add to the beauty of this structure, other Canadian tax rules would recharacterize the interest paid by *W* to *X* into active business income in the hands of *X*. The repatriation of those funds through *N* to the Canadian parent would be as a tax-free intercorporate dividend. The bank borrowing would give rise to two interest

deductions within the same economic corporate group. Under the protocol, any amounts received by a Canadian corporation would be subject to a 30% withholding tax rate. This withholding will apply when funds are moved from *X* to *N*.

Example 6: *C* and *D*, two U.S. corporations, are members in *K*, a Canadian partnership. *K* holds a 70% interest in a Canadian operating company. Since *K* is treated as a passthrough for both U.S. and Canadian tax purposes, no denial of treaty benefits would occur.

Permanent Establishments

The new provisions will deem an enterprise of one country to have a permanent establishment in the other country, where it otherwise would not have had such an establishment, if that enterprise provides services in the other country through an individual that is present in the other country for a period of 183 days or more in any 12-month period; during such period, more than 50% of the gross active business revenues of the enterprise consists of income derived from such services performed in the other country.

In addition, a permanent establishment will also be deemed to exist where the enterprise provides services in the other country for an aggregate of 183 days or more in any 12-month period for the same project (or connected projects) for customers who are residents of that other country or for customers who maintain a permanent establishment in the other country and the services are provided for that permanent establishment of the other customer.

These changes are effective January 1, 2010.

Limitation of Benefits (LOB)

Canada has agreed to apply the LOB provisions present in other U.S. tax treaties. Up to this point, only the United States has been applying those provisions. This new rule will ensure that Canada fully participates in combating “treaty shopping” and will give Canada the right to apply general tax abuse doctrine to ensure that transactions do not contravene the overall intent of the treaty provisions.

This provision can significantly affect certain “inbound” Canadian structures.

Example 7: *P*, a U.S. corporation, is a 49% member in *L*, a U.S. LLC. *M*, a Mexican corporation, is a 51% member in *L*. *L* owns 100% of *C*, a Canadian corporation.

As discussed earlier, under the new protocol the CRA will treat *L* as “fiscally transparent” and will look to the LLC members to determine treaty eligibility on Canadian source income. However, the LOB provisions will “trump” the lookthrough rules. In this example, because more than 50% of *L*’s revenue is not for the benefit of U.S. residents, the CRA will deny treaty benefits on all payments made by *C* to *L* and not just the 51% portion attributable to *M*. Dividends paid by *C* would be subject to a 25% withholding tax. This provision has caused a great deal of controversy. Based on

informal discussions with Canadian tax officials, the issue has been identified as requiring further analysis, and clarification is expected in the technical notes to the protocol.

Pension Contributions

In recognition of the mobility of employees between Canada and the United States and in order to not impair access to cross-border pension and annuity benefits, the protocol intends to modernize the pension provisions to recognize contributions made to nondomestic pension plans. Specifically, these provisions will affect individuals who reside in one country and work in the other country and make contributions to pension plans or other types of employment-related retirement arrangements in the country where they work. They will also affect those individuals who are transferred from their home country to the other country on a short-term work assignment (i.e., fewer than five years) and continue to contribute to their home country pension plans. In these cases, provided certain conditions are met, pension contributions made to nondomestic pension plans will qualify as contributions for resident country deductions. In both cases, benefits accruing in the plans will not be subject to current taxation.

Stock Options

In order to eliminate the confusion about which country retains the right to tax stock option benefits, the provisions provide clarity to the sourcing of stock options for those employees granted stock options while employed in one country who subsequently work for the same employer, or a company related to the same employer, in the other country, before exercising or disposing of the stock option (or the share).

Under these new sourcing provisions, the benefit will be sourced proportionately based on the location of the individual's principal place of employment between the time the option was granted and the time it was exercised (or the share was disposed of).

Although many practitioners have already been using this method of sourcing stock option benefits, these provisions remove the uncertainty associated with their allocation method.

Basis Adjustments for Emigrant's Gains

Currently, when a person relocates to the United States from Canada and at the time of the move owns assets that have unrealized gains, double taxation results from the absence of symmetry in the tax rules. Under the protocol, if a person with unrealized gains on property ceases to be a resident of one country and is treated as having disposed of certain property by that country, that individual can choose to have the deemed disposition and reacquisition event also apply in the new home country. This provision applies to dispositions (emigrations) after September 17, 2000 (seven years retroactive application).

Example 8: *E*, an emigrant from Canada to the United States, owns shares that cost \$100 and are worth \$1,000 at the time of her departure. Under the Canadian domestic tax rules, the “exit tax” provision triggers a deemed disposition and reacquisition of such property, resulting in the taxation of the \$900 gain in Canada. Under the protocol, *E* can choose to have this event occur for U.S. income tax purposes just before entering the United States. *E* obtains a bump up in the basis of her shares to \$1,000 (for U.S. and Canadian purposes), and any capital gain or capital loss on a future disposition of such shares while *E* is a resident of the United States will be computed using a tax basis of \$1,000.

Dispute Resolution

The new provisions add a binding arbitration procedure described as “mandatory arbitration” for the resolution of competent authority disputes. However, the process is entirely elective for the taxpayer. The new process is described as mandatory arbitration because it is mandatory for the revenue authorities if the taxpayer elects arbitration in a case. This new rule will apply to cases already under consideration when the protocol takes effect and to cases that subsequently come under consideration.

Conclusion

The above provisions should go far in removing barriers to the efficient application of the Canadian and U.S. tax rules. However, it is disconcerting that the countries took so long to reach agreement on matters that on the surface are not technically complex. These provisions all reflect changes driven and necessitated by the economic realities of the international investor and migrant worker. It is hoped that future changes will be accomplished efficiently and quickly in a manner that is more reflective of the speed with which business is nowadays conducted.



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