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TAX NOTES

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FIFTH PROTOCOL TO THE *CANADIAN-UNITED STATES INCOME TAX CONVENTION*

On September 21, 2007, the Canadian Minister of Finance and the US Secretary of the Treasury signed the Fifth Protocol (the "Protocol") to the *Canada-U.S. Income Tax Convention* (the "Convention"). This Protocol makes important changes to the Convention which should be of significant interest to our readership. This issue of Tax Notes is devoted exclusively to an analysis of the changes contained in the Protocol.

In order for the Protocol to enter into force, it must be ratified according to the applicable procedures in both Canada and the United States. In Canada, it will be necessary to pass a statute adopting the Protocol as part of Canadian law and both countries must exchange instruments of ratification. The Protocol will enter into force on the later of the exchange of instruments of ratification or January 1, 2008. The provisions of the Protocol will then have effect, with respect to withholding taxes, for amounts paid or credited on or after the first day of the second month that begins after the date on which the Protocol enters into force. Thus, if the Protocol enters into force on January 1, 2008, withholding tax changes will generally take effect on March 1, 2008. For other taxes, the Protocol will enter into force for taxable years that begin after the calendar year in which the Protocol enters into force (provided that if instruments of ratification are exchanged in 2007, the Protocol will be effective for other taxes for taxable years beginning on and after 2008). There are other special rules dealing with entry into force of specific provisions which are discussed in more detail below.

ELIMINATION OF "WITHHOLDING TAX" ON INTEREST

Clarke D. Barnes
Calgary
403.298.2402
cbarnes@millerthomson.com

Prior to the signing of the Protocol, the Convention provided that the country in which the payor of interest was resident was generally allowed to impose a withholding tax on such interest payments at a rate of up to 10%. Presently, the only generally available Canadian exemption from withholding tax on interest applies to interest payable by Canadian corporations on arm's length debt with a term of at least five years under which not more than 25% of the original principal amount may be repaid within five years (except on default or certain other specified circumstances) and that otherwise comply with a number of other detailed provisions under paragraph 212(1)(b)(vii) of the *Income Tax Act* (the "Act"). The Protocol makes a significant step in reducing the tax cost and compliance burden of arm's length cross-border financings by eliminating such withholding tax in the source country.

The new rule initially applies only to interest paid between arm's length persons as of the second month after the Protocol enters into force. Where the interest is paid between non-arm's length persons, the full exemption will be available as of the third calendar year ending after the entry into force of the Protocol. The withholding tax on interest payments between such related parties is reduced in stages for the interim period with the rate falling to 7% in the first calendar year ending after the entry into force, 4% in the second year and then 0% in the third and subsequent years. Finally, the Protocol also clarifies that guarantee fees are free from any withholding tax obligation.

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It is important to note that the eliminated or reduced rates as indicated above will not be applicable to interest payments arising in Canada and paid to U.S. residents where that interest is determined by reference to receipts, sales, income or other cash flow of the debtor or a related person or changes in the value of property of the debtor or a related person or, in the case of interest arising in the U.S. that payable to a Canadian resident, is contingent interest of a type that does not qualify as "portfolio interest" under U.S. law. Such interest will be subject, in either case, to a withholding tax rate of up to 15%.

On October 2, 2007, the Department of Finance released draft legislation implementing certain 2007 Federal Budget tax measurers. The draft legislation proposes to amend paragraph 212(1)(b) of the Act to implement the Budget's promise to eliminate the withholding tax on interest paid or credited to arm's length non-residents, regardless of their country of residence. Further, in light of the changes to the Convention to be made by the Protocol set forth above, a further exception is being added to paragraph 212(1)(b)(vii) referred to above permitting payment of more than 25% of principal within the first five years of issue of the debt obligation:

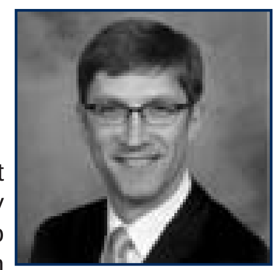
> "In the event that a change to this Act or to a tax treaty has the effect of relieving the non-resident person from liability for tax under this Part (i.e. withholding tax) in respect of the interest".

This amendment is to apply to all obligations entered into on or after March 19, 2007. Thus, assuming this provision becomes law, it would be possible to provide in a debt instrument for payment of more than 25% of the original principal amount within five years if the applicable statutory or treaty change has been made.

The draft legislation introduces the concept of "fully exempt interest" and proposes that a withholding tax will only be exigible under paragraph 212(1)(b) on interest that (i) is not fully exempt interest, and is paid or payable to a person with whom the payor is not dealing at arm's-length or (ii) is a participating debt interest. "Fully exempt interest" is interest paid by a Canadian resident to a non-resident person including interest paid on government and quasi government debt, on foreign real property mortgages (except where the interest is deductible in Canada), to prescribed international organizations and under certain securities lending arrangements. "Participating debt interest" is interest that is determined by reference to receipts, sales, income or other cash flow of the debtor generally. This provision will come into effect on or after the first day on which the Protocol generally precludes Canada from taxing interest paid by Canadian residents to arm's length US residents. Thus, upon the withholding tax provisions in the Protocol becoming effective, the statutory exemption will also have the same effect for all non-resident persons regardless of residents. The draft legislation also proposes to eliminate the "Certificates of Exemption" that had previously been issued by the Minister to non-residents under Section 212(14) of the *Income Tax Act*, as they will no longer be needed in light of the general exemption provided for above.

LIMITED LIABILITY COMPANIES AND HYBRIDS

Joseph W. Yurkovich
Edmonton
780.429.9716
jyurkovich@millerthomson.com



The Protocol delivers on the federal government's pledge to clarify Canada's position on the treaty entitlement of U.S. limited liability companies (LLCs). Somewhat surprisingly, along with the relief provided for "fiscally transparent" LLCs, the Protocol also introduces some unanticipated new rules that will deny treaty benefits to "hybrid" entities; business forms that are fiscally transparent in one country, but taxable as separate entities in the other. A table summarizing the treaty entitlements of fiscally transparent entities is appended at the end of this article.

"Fiscally Transparent Entities"

Consistent with recent amendments to other U.S. tax treaties, the Protocol introduces the concept of the "fiscally transparent entity" into the Convention, a new concept for Canadian income tax purposes. According to the Internal Revenue Service, each amount received by an entity must be separately tested for the determination of fiscal transparency using the law of the jurisdiction where the holder of an interest in an entity is resident (in this article, the "Home Country"). An entity will be fiscally transparent where the Home Country requires the entity's share of the subject amount to be taken into account on a current basis by the owners, regardless of whether those amounts are distributed to them *and* the amount retains its character and source, as if it had been earned by the owners of the entity directly from the source that paid it to the entity. This definition may deny benefits in respect of some types of Canadian income, such as certain distributions from a trust, which is subject to source recharacterization as it flows through the trust to beneficiaries.

Limited Liability Companies

Presently, the Canada Revenue Agency takes the position that an LLC that has elected flow through characterization under the U.S. "check-the-box" regulations is not a U.S. resident entitled to treaty benefits. The Protocol extends treaty benefits to the U.S. resident members of fiscally transparent U.S. resident LLCs for income, profit or gain that is subject to U.S. tax as if it had been derived directly by those U.S. residents. By amendments introduced in respect of Article X of the Convention, shares of a Canadian corporation held by a fiscally transparent LLC will be deemed to be owned by the members of the LLC for the purpose of determining taxation in accordance with the Convention of dividend distributions. Together, these amendments will facilitate and encourage the use of LLCs for the conduct of the Canadian business operations of U.S. based enterprises.

The relief provided for members of fiscally transparent LLCs is part of a more broadly worded relieving provision (new paragraph IV 6), which provides for a person resident in one of Canada and the U.S. (the Home Country) to be considered to have been paid or to have derived an amount that is received through any entity that is not resident in the other country (in this article, the "Source Country"), so long as the entity is fiscally transparent in the Home Country and the tax treatment there of the amount is the same as if the amount had been paid or derived directly by the person. Note that the only restriction on residency of the fiscally transparent entity is that it not be resident in the Source Country. As noted below, this has serious implications for Canadian flow through entities and hybrids, such as ULCs.

Hybrids

Subject to the apparent relief that is provided by paragraph IV 6 for members of hybrid entities that are not resident in the Source Country, the Protocol introduces rules (in subparagraphs IV 7 (a) and (b)) that deny flow through treatment to fiscally transparent hybrid entities.

Home Country Fiscally Transparent Entities

Subparagraph IV 7 (b) applies in similar circumstances to paragraph IV 6. In each case, the entity is one that is fiscally transparent in the Home Country. Subparagraph IV 7(b) provides an exception to the broader rule in paragraph IV 6, and denies flow through treatment where the entity is resident but not fiscally transparent in the Source Country. Entities in common use that fit this fact pattern include Canadian unlimited liability corporations and companies (ULCs). Subparagraph IV 7 (b) will operate to cause amounts paid to or derived by a U.S. resident person from a ULC to be considered not to have been paid or derived directly by that U.S. resident.

An obvious result of these rules will be to halt the use of ULCs as the operating entity for a U.S. enterprise's Canadian operations, where consolidation of the Canadian operations or the push down of group debt to the Canadian operating level is desired. The rules will also prevent the use of ULCs to structure Canadian share acquisitions as asset purchases for U.S. tax purposes.

Source Country Fiscally Transparent Entities

Paragraph IV 7 (a) provides the new rule for hybrid entities that are fiscally transparent only in the Source Country. In such circumstances, an amount will be considered not to have been paid to or derived by a resident of the Home Country, resulting in a denial of treaty benefits to the recipients of the amount. A common structure that this rule is designed to counter is a "synthetic NRO" partnership structure, wherein U.S. corporations form a Canadian partnership and check the box for flow through U.S. tax treatment. Under the current rules, Canada would be required to provide treaty benefits to the U.S. partners for interest paid to them.

Coming into Force

Since these rules will have implications for business structures presently in place, the Protocol proposes that these new restrictions will take effect at the start of the 3rd calendar year ending after entry into force. Presuming ratification effective January 1, 2008, these restrictions will therefore come into force January 1, 2010.

Corporate Law Considerations

CRA's denial of treaty benefits to fiscally transparent LLCs provides a strong disincentive against the use of LLCs in the conduct of Canadian operations. The relief provided pursuant to the Protocol, combined with the proposal to deny treaty benefits in respect of the common ULC structure, will result in a surge in applications for extra-provincial LLCs that the corporate law regimes of some provinces may not presently be designed to accommodate easily. For example, while Alberta has since January, 2006 permitted the extra-provincial registration of LLCs, the current administrative practice is to do so only where the LLC provides a legal opinion from a lawyer in the LLC's home jurisdiction which describes the general characteristics of the LLC in the home jurisdiction and confirms (essentially) the separate corporate status of the LLC in that home jurisdiction.

New Rules for Fiscally Transparent Entities

Entity residency	Place(s) where entity regarded as fiscally transparent	Amount paid or derived by person resident in Home Country	Treaty Provision
Source Country	Home Country	No (no flow through)	IV 7(b)
Anywhere except Source Country	Home Country or Both	Yes (flow through)	IV 6
Source Country	Both	Yes (flow through)	None
Anywhere except Home Country	Source Country	No (no flow through)	IV 7(a)

TAXPAYER MIGRATION

Alessandra Prioreschi
Kitchener-Waterloo
519.593.3272
aprioreschi@millerthomson.com

Individuals emigrating from Canada to the U.S. may be particularly interested in the changes to Article XIII of the Convention, which may eliminate double taxation on emigration. Once the Protocol has been ratified, these changes will apply from September 18, 2000.

Under Canadian income tax law, where a Canadian resident individual emigrates, he or she is deemed to dispose of and reacquire all of his or her property at its fair market value, with certain exceptions (such as Canadian real estate, capital property, RRSPs, RRIFs, an interest in a trust or life insurance policy). Any capital gain or income earned on the deemed sale must be reported by the individual in his or her tax return for the year in which he or she became a non-resident of Canada. This tax is often referred to as the "departure tax."

Paragraph 7 of Article XIII applies where an individual has been deemed by a Contracting State, for example Canada, to dispose of property on emigration, with the result that tax in Canada applies to any gains inherent in the property subject to the deemed disposition. Under the former provisions, the property which was subject to Canadian departure tax could also be taxed in the U.S., the other Contracting State. In particular, former paragraph 7 of Article XIII provided that an individual could elect for U.S. tax purposes to be liable for U.S. tax which could be deferred but not forgiven in respect of the property that was deemed sold under Canadian law.

The Protocol amends the paragraph by permitting an individual to elect for U.S. tax purposes to be treated as having sold and reacquired the property at its fair market value. The result for the individual emigrating from Canada and so electing is that he or she will have the benefit of a bumped up cost base for U.S. tax purposes on the property deemed disposed of, so that if and when he or she does sell the property, U.S. tax will only apply to the gain resulting from the time of emigration. Double taxation will thus be eliminated.

The Department of Finance News Release of September 18, 2000, commenting on the then proposed changes, notes that "where tax is payable in the destination country -- for example, where the property in question is real estate situated in that country -- the new rule will ensure appropriate tax crediting." However, paragraph 1 of Article XIII of the Convention, which applies to gains derived from a sale of real property, should be kept in mind.

STOCK OPTIONS

James A. Hutchinson
Toronto
416.597.4381
jhutchinson@millerthomson.com

Included in the various tax measures set out in the Protocol are new rules that will clarify how stock options are taxed. Currently, there is ambiguity with respect to the sourcing of stock options in the situation where an employee who is granted a stock option while employed in one country (i.e., Canada) then works for the same or a related employer in the other country (i.e., the United States) before exercising or disposing of the option. Prior to the Protocol, there was no specific rule that provided for the apportionment of the stock option benefit between Canada and the United States.

The Protocol provides that for the purposes of applying Article XV (Income from Employment) and Article XXIV (Elimination of Double Taxation) of the Convention to income of an individual in connection with the exercise of an option that was granted to the individual as an employee of a corporation or mutual fund trust in respect of services rendered by such individual, the individual shall be deemed to have derived the same proportion of such income that the number of days in the period that begins on the day the option was granted and ends on the day the option was exercised or disposed of, in which the individual's principal place of employment for the employer was situated in that Contracting State is of the total number of days in the period on which the individual was employed by the employer.

In other words, the stock option benefits that is to be attributed to either Canada or the United States would be calculated as follows:

$$\frac{A}{B} \times C$$

Where A = the number of days in the period in which the individual's place of employment was in the respective Contracting State,

B = the number of days in the period that begins on the day the option was granted and ends on the earlier of:

(i) day the option was exercised or disposed of,

or

(ii) the individual ceases employment with the employer, and

C = the amount of the stock option benefit calculated without reference to these rules.

The above rule is subject to the condition that if the competent authorities of both Canada and the United States agree that the terms of the option was such that the grant of the option will be appropriately treated as transfer of ownership of the securities (i.e., because the options were in the money or not subject to a substantial vesting period) then the competent authorities may agree to attribute income accordingly.

The example provided in the Notes to the Protocol is as follows:

> "An employee of a United States company is granted a stock option on January 1, 2009. On January 1, 2010, the employee is moved from the company's US head office to its 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 the parting from the usual rule, one-third of the income will be treated as having a residence in the US and two-thirds in Canada".

The stock option changes introduced by the Protocol will assist in providing some certainty in the taxation of cross border stock option benefits.

PENSIONS AND OTHER REGISTERED PLANS

Rosanne Rocchi
Toronto
416.595.8532
rrocchi@millerthomson.com

The Protocol contains amendments to Article XVII of the Convention, which addresses pensions and annuities. The principal changes affect cross border commuters and temporary secondments for specific work arrangements. They provide for deductibility of contributions to registered pension plans and for the exemption from taxation for any accruals in such plans.

Cross Border Commuters

The Backgrounder issued by the Department of Finance addresses the matter as follows:

> "Provided certain conditions are met, cross border commuters may deduct, for resident country tax purposes, the contributions they make to a Plan or arrangement in the country where they work."

The new rules for cross border commuters are effected by amendments to Article XVIII of the Convention by the addition of paragraphs 13 and 14. These provide that contributions made to a qualifying retirement plan in Canada by or on behalf of a citizen of the U.S. who is resident in Canada will be deductible in computing the citizen's taxable income in the U.S. where that citizen performs services as an employee in Canada, the remuneration from which is taxable in Canada and is borne by an employer that is a resident of Canada. The contributions must be attributable to those services.

A similar provision in paragraph 14 addresses the mirror situation of a Canadian resident who performs services as an employee in the U.S.

Temporary Work Assignments

The other significant amendment effected by the Protocol is to provide that those who travel for work on a temporary basis may secure mutual recognition for pension contributions. Again, the Backgrounder summarizes these new rules as follows:

> "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."

The sections which address the amendments for temporary workers are contained in paragraphs 8, 9, 10, 11 and 12 which are added to Article XVIII of the Convention. The drafting in these sections is troublesome and it is anticipated that there will be some fine tuning of these sections in the future.

One of the conditions for the mutual recognition of deductibility and non-taxable accrual is that the individual must work in the other State for the same employer for no more than 60 of the 120 months preceding the individual's current taxation year. Consequently, the new mutual recognition guidelines are only available in circumstances where the assignment is a temporary one with a limit of 5 years, although such 5 years need not be consecutive.

The troublesome aspect some of the new "relief" measures in the Protocol is that the circumstances anticipate situations which are not typical. The Backgrounder uses the following example:

> "An employee of a Canadian company is assigned for three years to a related US company. The employee keeps contributing to the Employee Pension Plan of the Canadian company. For U.S. tax purposes, both the employee and the U.S. Company will be able to deduct the contributions."

As a practical matter, an employee who is assigned to a related U.S. company may not be eligible to continue participation in the Canadian pension plan particularly since most Canadian pension plans provide that the member must be employed in Canada in order to qualify for membership. Secondly, the rule anticipates a situation whereby the U.S. employer makes a contribution to the Canadian pension plan, whereas the sponsor of the Canadian pension plan is generally the Canadian company and such plans do not generally include participation by related foreign companies.

Although it is clear that the intention of the Protocol is to facilitate movement of personnel for mutual recognition of pension plans and contributions, some modification may be necessary to ensure that the language of the Protocol effects the relief that is anticipated.

It is anticipated that the [possibly inadvertently] missing language that would capture all the different temporary arrangements that are crafted to accommodate personnel seconded to a U.S. or Canadian affiliate will likely affect the employer corporations rather than the employees. As a practical matter, many employees who are assigned on a temporary basis have tax equalization clauses built into an employment contract, so that any tax disadvantages experienced as a consequence of the relocation are recognized by the employer. The employee is in effect "made whole" by the tax equalization payment.

Limitations on Deductions

Despite the intention of mutual recognition, each Contracting State will only permit a deduction up to the maximum amounts permitted in that State. This will require an annual review since these amounts frequently change.

Qualifying Retirement Plan

The Protocol defines a "qualifying retirement plan" as an arrangement:

(a) that is a resident of that state, generally exempt from income taxation in that state and operated primarily to provide pension or retirement benefits; and

(b) that is not an individual arrangement in respect of which the individual's employers have no involvement.

It is Item (b) that takes away some of the flexibility and benefit for individuals who supplement corporate pension plans by using the balance available for contribution into a personal RRSP. The Protocol recognizes contributions to an employer sponsored plan. It does not recognize contributions made to an RRSP unless it is part of a group RRSP.

Like other aspects of the Protocol, some experience will be necessary before the flaws appear. As the intention of the Protocol is to facilitate rather than to impede the flow of personnel between the two countries, it is anticipated that modification of the rules will occur as input from the private sector results in a closer scrutiny of the application of the new rules.

NEW CANADA - U.S. TAX CONVENTION PROTOCOL: MANDATORY ARBITRATION

Daniel L. Kiselbach
Vancouver
604.643.1263
dkiselbach@millerthomson.com

The Protocol sets out a number of tax dispute resolution rules. Amongst other things, taxpayers may elect to refer tax some disputes to mandatory arbitration. Mandatory arbitration is designed to encourage early negotiated settlements of tax disputes arising under the Convention. Details respecting the new rules are set out below.

It may be useful to generally describe the dispute resolution process currently provided for under the Convention. The Convention is designed, in part, to eliminate the double taxation of Canadian or U.S. residents. The terms of the Convention are considered by Canadian and U.S. revenue authorities who may differ in their approaches to the interpretation and application of the Convention. Disagreements may arise respecting such matters as the amount of income, expense or tax reportable in Canada or the U.S. Such disagreements may lead to potential cases of double taxation. Taxpayers who believe that they may be subjected to tax contrary to the terms of the Convention may present a case to a Canadian or U.S. revenue authority (the "competent authority"). A taxpayer must present a case to the competent authority of the country in which he or she is resident, or of which he or she is a national.

The Convention provides rules for the resolution of tax disputes arising from the application or interpretation of the Convention. Article XXVI - "Mutual Agreement Procedure" states that competent authorities should attempt to resolve cases by mutual agreement. Obviously, competent authorities have not always resolved cases by mutual agreement. It was necessary to implement an arbitration process in order to reduce the chance that a tax dispute will go unresolved.

Where competent authorities have not reached an agreement on how to resolve a case some taxpayers may refer certain cases to mandatory arbitration. The Protocol will apply to both current and future cases. Arbitration will be available in respect of case referred to in the Convention and specified in the Diplomatic Notes: Annex A to the Protocol. These include: Article (IV) (residence in relation to a natural person); Article V (permanent establishment), Article VII (business profits), Article IX (related persons) and Article XII (specified transactions involving royalties). There are exceptions. Competent authorities may agree that a case is not suitable for arbitration. Further, competent authorities may agree to refer other matters to arbitration.

The arbitration board will be constituted of three members. Its role will be to determine the amount of income, expense or tax that is reportable to Canada or the U.S. Competent authorities in Canada and the U.S. may provide the arbitration board with a proposed resolution. The arbitration board must adopt one of the proposed resolutions. If only one resolution has been provided, then it shall be deemed to be the resolution of the board.

The new mandatory arbitration rules are designed to improve access to justice for taxpayers. The arbitration board may adopt any procedures it deems necessary in order to arrive at a determination. Proceedings must begin within two years of the commencement date of the case or the date that the taxpayer signs a required non-disclosure agreement, and a determination must be made within six months of the appointment of the chair. Finally, a taxpayer is not bound by a determination. If a taxpayer does not provide notice of acceptance, then the determination shall be considered not to have been accepted. In sum, mandatory arbitration should provide taxpayers with a relatively accessible, speedy and risk free dispute resolution option.

MILLER THOMSON LLP TAX GROUP

Toronto/Markham

Dalton Albrecht	416.597.4360
Rachel L. Blumenfeld	416.596.2105
John M. Campbell	416.595.8548
Gerald D. Courage	416.595.8163
James A. Fraser	416.595.8594
Robert B. Hayhoe	416.595.8174
Leela Hemmings	416.595.8623
James A. Hutchinson	416.597.4381
Kate Lazier	416.595.8197
Susan M. Manwaring	416.595.8583
Martin J. Rochwerg	416.596.2116
Amanda J. Stacey	416.595.8169
Katherine Xilinas	416.595.8165

Vancouver

Sarah D. Hansen	604.643.1273
Daniel L. Kiselbach	604.643.1263

Calgary

Clarke D. Barnes	403.298.2402
Dean J. Barrett	403.298.2427
Esmail Bharwani	403.298.2418
William J. Fowlis	403.298.2413
Bryant Frydberg	403.298.2456
Gregory P. Shannon	403.298.2482
Rhea Solis	403.298.2451

Edmonton

Wendi P. Crowe	780.429.9764
Joseph W. Yurkovich	780.429.9716

Kitchener-Waterloo

Stephen R. Cameron	519.579.3660
Alessandra Prioreschi	519.593.3272

Montréal

Richard Fontaine	514.871.5496
Betrand Leduc	514.871.5451
Normand Royal	514.871.5453

MILLER THOMSON LLP INTERNATIONAL TRADE/CUSTOMS/ COMMODITY TAX LAWYERS

Dalton Albrecht	416.597.4360
Daniel L. Kiselbach	604.643.1263
Bertrand Leduc	514.871.5451
Katherine Xilinas	416.595.8165
Joseph W. Yurkovich	780.429.9716

www.millerthomson.com