# The New Canada-U.S. Tax Treaty

Craig Burley

***Canada-U.S. Protocol***

The Fifth Protocol (the "Protocol") to the *Canada-U.S. Tax Convention, 1980* (the "Treaty") entered into force on December 15, 2008, nearly ten years after negotiation of the Protocol first commenced. The Protocol's passage significantly changes the taxation of cross-border transactions between Canada and the U.S. Withholding taxes on cross-border interest payments are to be eliminated, treaty benefits are to be extended to U.S. limited liability companies ("LLCs"), and Treaty benefits are to be denied to certain "hybrid" entities. New provisions shall allow taxpayers to require that Treaty issues such as transfer pricing be settled through mandatory arbitration.

***Withholding Tax on Cross-Border Interest***

Until recently, interest paid by a resident of Canada to a resident of the U.S. was subject to a 10% withholding tax. While U.S. borrowers had a broadly-available exemption from such withholding tax, Canada's exemption was often difficult for borrowers to access. This resulted in higher borrowing costs and reduced access to the U.S. capital markets for Canadian businesses, as borrowers inevitably bore the cost of the withholding tax.

The withholding tax on cross-border interest for arm's length parties (for all countries) was eliminated as of the 2008 taxation year; however, the existing regime remains in place for non-arm's length borrowers. The Protocol will phase in the elimination of cross-border withholding tax between non-arm's length parties in Canada and the U.S. The withholding tax is retroactively reduced to 7% for the 2008 calendar year, to 4% for the 2009 calendar year, and eliminated entirely for subsequent years, therefore bringing such withholding taxes into line with the treatment of interest payments to non-resident arm's length lenders by 2010.

One important qualification to the withholding tax exemption with respect to Canadian source interest is that various types of so-called "participating interest" will be subject to the normal Treaty rate of withholding tax of 15% rather than 0%. This will apply to interest, "determined with reference to receipts, sales, income, profits or other cash flows of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor or a related person."

These changes are having a significant impact on cross-border acquisitions. Access to capital for acquisition transactions and operating lines will increase significantly as it will be easier to access both U.S. and international debt markets, and borrowing costs will be reduced as there will no longer be the need to gross-up a foreign lender for Canadian withholding tax.

***Treaty Benefits for LLCs***

The Protocol also introduces welcome changes to the treatment of U.S. LLCs. The Canada Revenue Agency ("CRA") has historically denied Treaty benefits to LLCs that are treated as "fiscally transparent" for U.S. tax purposes. CRA's position has been that while an LLC is a corporation for Canadian tax purposes, an LLC that is a disregarded entity for U.S. tax purposes (i.e. those that have "checked the box" to elect to be treated as disregarded) is not a resident of the U.S. for purposes of the Treaty because it is not subject to tax in the U.S. Compounding this difficulty, the members of the LLC also do not enjoy the benefits of the Treaty in respect of their participation in the LLC. LLCs have therefore historically been subject to high rates of withholding tax and other punitive treatment on their Canadian investments.

The Protocol contains a new provision to allow U.S. residents who derive Canadian source amounts through an LLC to benefit from the Treaty. The Protocol does not extend the benefits to the LLC, but applies them to U.S. resident members of the LLC with respect to income and gains realized "through" the LLC.

This provision is effective for taxation years beginning on or after February 1, 2009. If, however, the income of the LLC is not taxed directly in the hands of its U.S investors, the income will be treated as not having been earned by a resident. This corollary rule will apply as of January 1, 2010.

This new Treaty provision will facilitate U.S private equity funds making investments in Canada being structured as LLCs rather than partnerships, as U.S. fund managers often prefer for investment domestically or in other countries. However, these new Protocol provisions are likely to create certain administrative and filing headaches, as LLCs may need to obtain additional information from their members and provide this information to CRA in order to obtain treaty benefits for those members. For funds with non-U.S. investors, LLCs will not likely be an attractive structure. Non-U.S. investors will not be entitled to the benefits of a tax treaty between the investor's country of residence and Canada, nor will they be entitled to the "flow-through" treatment given to U.S. residents.

***Binding Arbitration***

Residents of the U.S. and Canada may find themselves in situations where they are subject to double taxation, and where the Treaty does not provide a resolution. Prior to the coming into force of the Protocol, if the treaty rules did not provide for a resolution to a double taxation problem, the matter was left to be resolved between the revenue authorities. Unfortunately, if a double taxation issue could not be resolved by the mutual agreement of the revenue authorities there was no further mechanism for dispute resolution.

The Protocol introduces provisions to allow taxpayers to elect for binding arbitration, participation in which is mandatory for the revenue authorities. This mechanism of mandatory arbitration will be particularly important in cases of transfer pricing audits by Canada or the U.S.

Importantly, the discretion to proceed with or withdraw from the arbitration process lies with the taxpayer. The decision to elect for arbitration is entirely within the taxpayers' hands. Further, the taxpayer retains the right to reject the arbitration committee's final determination, and can choose to pursue a remedy within the judicial system.

The arbitration provisions of the Protocol are effective as of December 15, 2008, and apply not only to disputes arising after this date, but also to matters already under consideration by the revenue authorities.

***Limitation of Benefits and Hybrid Entities***

Not all of the Protocol's changes are good news for taxpayers. The Protocol also introduces new limitation of benefits ("LOB") provisions. Previously, the Treaty's limitation of benefits provision only permitted the U.S. to deny benefits to certain Canadian taxpayers; now, the new LOB provisions are also to be applied by Canada.

This is the first time that Canada has included a LOB provision in a tax treaty.

A resident must satisfy a "qualifying person" test, an "active business" test, or a "derivative benefits" test under the LOB rules in order to be entitled to Treaty benefits. Not all U.S taxpayers will be able to access treaty benefits as a result, or may find their Treaty benefits restricted. For example, Treaty benefits may now be restricted for a U.S. subsidiary of a foreign parent corporation. This provides an alternative method to deny Treaty benefits where CRA views arrangements as abusive treaty shopping[1] but it will extend well beyond what is normally understood by tax practitioners as "treaty shopping".

The LOB provisions will apply as of February 1, 2009 for withholding taxes, and tax years beginning after December 31, 2008 for all other taxes. It is anticipated that the LOB provisions will result in increased administrative costs for taxpayers, as well as require companies to exercise greater control over and know more about, their shareholders, in order to assess the potential application of the LOB provisions.

In addition, the corollary rule (as discussed in connection with LLCs above) will deny benefits to persons holding an interest in certain "hybrid" entities (entities treated as a corporation in one country, and as a flow-through entity in the other), such a Canadian unlimited liability companies ("ULCs"). ULCs have become a popular tax planning tool to facilitate U.S. investment into Canada. Under U.S. law, ULCs are eligible to be treated as fiscally transparent, which allows for losses to flow through to U.S shareholders.

This change could have a significant impact on "push down" debt structures or "reverse hybrid" structures as well as cross-border acquisition structures involving a ULC as the Canadian acquisition vehicle. Any existing cross-border corporate structures that include a ULC component should be reviewed before the effective date of this provision, January 1, 2010.

[1] In the past, CRA has relied on the "general anti-avoidance rule" in domestic tax legislation to address the issue of treaty shopping. ■

*Craig Burley is an associate at Gowling Lafleur Henderson LLP in Hamilton. He can be contacted at:* 905-540-8208.