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Accountants and Consultants

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## Subject:

### **United States and Canada Sign Fifth Protocol to U.S.-Canada Income Tax Convention**

# International Tax Alert

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On September 21, 2007 the United States and Canada signed the Fifth Protocol to the US-Canada Income Tax Convention.

The current US-Canada Income Tax Convention was signed in 1980 and has been updated four times previously—in 1983, 1984, 1995 and 1997. The Fifth Protocol (the Protocol) signed on September 21, 2007 proposes changes and updates several of the provisions of the existing US-Canada Tax Convention. In addition, two sets of diplomatic notes were also exchanged.

The Protocol will enter into force once it is ratified by both the US and Canadian governments (or on January 1, 2008 if ratified in 2007). Specific changes may have their own in force date and are summarized below with the applicable Protocol provision.

The key changes in the Protocol include:

#### **Elimination of Withholding Tax on Interest Payments.**

Interest paid by a borrower in the source country will not be taxed by the source country. The lender's country has the right to tax the interest. The elimination of the withholding tax on interest reduces the borrowing costs of borrowers whether they borrow from unrelated or related borrowers. This change is subject to a transition rule for related party payments that reduces the rate of withholding from the current 10% to 7% in the first year after the Treaty is in force and then 4% in the second year and the zero rate in the third year. For payments of unrelated interest the change is effective after the second month after the Protocol enters into force. Canada had previously announced its intent to remove withholding on unrelated interest payments last March.

#### **Guarantee Fees**

Under the new Protocol, guarantee fees with respect to debt will only be taxable in the recipient's country of residence unless the fees are

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business profits attributable to a permanent establishment in the other country. This change is effective for taxable years that begin after the calendar year in which the protocol enters into force.

### **Dividends**

The new Protocol contains no dividend withholding tax reduction for dividends paid from 80% or more owned subsidiaries to its corporate parent company. Recent US treaties have included a zero rate of withholding tax provision for such dividends. However, some changes were made with respect to dividend withholding. A 5% rate of dividend withholding is available to US corporate owners of a fiscally transparent entity holding Canadian shares if the corporate owners would otherwise be eligible for the reduced withholding if the corporation held the shares directly rather than through the fiscally transparent entity. This change is important as Canada has previously indicated that such ownership was indirect and thus was not eligible for the lower rate of withholding. The exchange of notes clarified that the definition of a dividend also includes a distribution from a Canadian royalty trust or income fund. The Protocol also provides for reduced US withholding tax on certain REIT distributions.

### **Limited Liability Companies (LLCs) and Other Hybrid Entities**

The Protocol brings some clarity with regard to the use of LLCs and other hybrid entities. Under the current treaty, hybrid entities are not entitled to treaty benefits, which can cause problems. In order for an entity to be eligible for benefits under the treaty, such as reduced withholding taxes, an entity must be resident in one of the treaty countries and the entity must be liable for tax in that country. If an entity is a pass-through vehicle in its own country, such as an LLC, it is not eligible for benefits under the current treaty as the entity itself is not liable to tax.

The Protocol contains measures to address this problem. Income earned by a resident of one country through a hybrid entity, such as an LLC, will be treated by the other country as having been earned directly by the resident in determining whether treaty benefits are available. For example, if US resident investors use an LLC to invest in Canada (which is a corporation for Canadian purposes and a pass-through vehicle for US purposes), any Canadian source investment income earned by the LLC will be eligible for reduced withholding taxes under the treaty because Canada will now treat the income as though it was paid directly to the US resident investors in determining whether treaty benefits apply. Note, however, a corollary rule provides that if the hybrid entity's income is not taxed directly in the hands of its investors, it will not be treated as having been earned by a resident and treaty benefits will not be available.

This change will apply for withholding tax purposes as of the second month after the protocol enters into force. The corollary rule applies after two years.

### **Denial of Treaty Benefits for Certain Hybrid Entities**

The Protocol denies treaty benefits with respect to certain cross-border structures used by Canadian and US investors. This provision has two rules that apply to certain payments between the US and Canada with the use of hybrid entities.

The first rule denies Treaty benefits on payments to, or amounts derived by, a resident of one contracting state through a hybrid entity that is recognized by that state but is disregarded by the other state. The second rule denies Treaty benefits on payments to, or amounts derived by, a resident of one state from a hybrid entity that is disregarded by that state but is recognized by the other state.

The intended application of this provision to cross-border structures used by US and Canadian investors is not clear. This provision may have wide application over many structures that have been used in recent years to take advantage of differences in US and Canadian taxation of entities and payments.

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This provision is in force the first day of the third year after the Protocol comes into force, thus allowing some time to restructure certain outbound and inbound US-Canada tax planning.

### **New Rules for Pension Contribution Deductions**

Over the years, more and more employees work in one country but contribute to a pension plan in the other country. From a Canadian perspective, this would include individuals who live in Canada and commute to the United States daily to work and contribute to a US pension plan. Another example would be a Canadian resident employee that works in the United States on a short-term basis and continues to contribute to a Canadian pension plan while resident in the United States. Under current rules, there is no certainty that the employee can deduct the contributions made to the foreign plan.

Under the Protocol, a deduction for pension contributions in the other state will be allowed, subject to a number of conditions and limitations. One rule qualified residents of each country should consider is that the new pension plan contribution deduction will be limited to the taxpayer's contribution limit, in their country of residence in addition to any limitation in their home country.

This change will apply for taxation years that begin after the calendar year in which the Protocol enters into force. However, if ratification is completed in 2007 the rule applies for taxation years that begin in 2008.

### **Double Tax Relief for Stock Options**

The use of stock options as a form of remuneration for employees has become very common. Many employees may be granted and exercise stock options in different countries while employed in Canada and the United States.

As part of an exchange of diplomatic notes as opposed to a treaty change, a new test will apply to determine which country can tax the option benefit. The stock option benefit will generally be considered to have been derived in a country to the extent that the individual's principal place of employment was in that country during the time between the granting of the option and its exercise. It would appear that this rule will apply where the employee is employed by the same employer or related employers on each side of the border.

The Canadian Department of Finance cited an example where an employee of a US 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. Except in unusual circumstances, the taxation of the stock option benefit will be prorated—one third of the resulting benefit will be deemed to have been derived in the US tax and two thirds will be deemed to have been derived in Canada. This change will enter into force at the same time as the Protocol.

### **New Mandatory Arbitration Rule**

Under the current version of the treaty, various rules apply to determine which country can levy tax, and when these rules do not eliminate double taxation, the final point of relief is a mutual agreement between tax authorities of both countries on who will tax the item in question. However, this doesn't guarantee that such an agreement will in fact be reached and therefore, double tax may still arise.

Under the Protocol changes, a new rule will be available to taxpayers. If the tax authorities of both countries fail to reach an agreement on a double tax issue and if a taxpayer so elects, he or she can ask for arbitration of the issue. However, it is not clear how beneficial this rule will be. First, it appears that the governments of each country can decide which articles of the treaty will be subject to arbitration. In addition, it would appear that arbitration on an issue can be denied if both countries agree, before

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the date on which arbitration proceedings would otherwise have begun, that the issue is not suitable for determination by arbitration.

This change applies to cases that are, when the Protocol enters into force, already under consideration under the treaty's mutual agreement procedure, as well as cases that subsequently come under consideration.

### **Service Providers and Deemed Permanent Establishments**

As a general rule, a service provider who is resident in one country is subject to income tax in the other country only if it provides services through a permanent establishment in the other country. However, some US states impose tax based on nexus (as opposed to permanent establishments), and are not bound by the treaty.

A permanent establishment is defined under the current treaty to include a fixed place of business, such as an office. In recent years, however, both the Canadian and US authorities have been aggressive in arguing that service providers from the other country have permanent establishments in their country, and are therefore subject to tax there, even though it is not clear whether they are providing those services through a fixed base of business in their country.

To provide more certainty in this area, the new protocol contains a new deemed permanent establishment rule for service providers. Basically, a service provider, resident in one country, will have a permanent establishment in the other country if those services are performed by an individual who is present in the other country for 183 days or more in any 12 month period and during that period, more than 50% of the gross active business revenue of the enterprise consists of income derived from the services performed by that individual in the other country. In addition, a service provider will have a deemed permanent establishment in the other country if services are provided in the other country for 183 days or more in any 12 month period with respect to the same or connected project for customers who are resident of the other country or who maintain a permanent establishment in that other country and the services are performed in respect of that permanent establishment.

This change will be effective as of the third taxable year that ends after the protocol enters into force. However, it will not apply to services rendered or business revenues that occur or arise prior to January 1, 2010.

### **Deemed Cost Step-Up on Emigration**

A change that was first announced just over 7 years ago has been included with this Protocol. Under Canadian rules, when an individual becomes a Canadian resident, he or she will be deemed to acquire most capital properties at their value on entry into Canada for capital gains purposes. Similarly, an individual leaving Canada is deemed to dispose of most capital properties and will be subject to tax on the gains and losses that arise. In the United States, individuals are taxed on gains realized on most properties based on their original cost. Therefore, for Canadians emigrating to the United States, double tax can arise—on the deemed departure disposition for Canadian purposes and on a subsequent sale of the asset for US purposes. To avoid this problem, emigrants historically sold their investments prior to taking up US residency and reacquired them

As first announced in 2000, the Protocol contains a change that will ensure that Canadians emigrating to the United States will not be subject to double tax. In particular, the individual can elect to sell and repurchase a property at an amount equal to its fair market value at the time immediately before becoming a non-resident of Canada. It appears this election can be made on a property-by-property basis. This change applies to properties that are deemed to have been disposed of after September 17, 2000. It should be noted that this change does not apply to assets held within an RRSP and certain other indirect holdings.

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## **Corporate Continuations**

Under the new protocol, a company incorporated in one country that continues into the other will still be treated as a resident of the first country unless that country's internal law no longer treats it as such. For example, a US corporation that continues into Canada but retains its status as a US corporation will, under the treaty, become a Canadian resident while remaining a US resident. Such a corporation will not be entitled to any benefits under the treaty except to the extent agreed upon by the competent authorities of the two countries. This change applies to continuances effected after September 17, 2000.

## **Limitations on Benefits**

The Protocol updates the Treaty article on the limitation on benefits (LOB). This expanded LOB article is applicable to both the US and Canada. This represents Canada's first comprehensive bilateral LOB provision.

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