



## New Protocol to the Canada-U.S. Tax Convention

“Looking Ahead and Being Innovative”

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## Highlights of the Protocol



- Eliminates 10% withholding tax on cross-border interest payments
- Extends treaty benefits to fiscally transparent entities
- Establishes a binding arbitration process
  - Transfer pricing is a key double taxation issue
- Provides mutual tax recognition of pension contributions
- Provides sourcing of stock option benefits

# Highlights of the Protocol



- Two sets of diplomatic notes
  - Annex A details binding arbitration procedures
  - Annex B addresses various interpretive issues
- Other Changes
  - Determination of business profits
  - Limitation of benefits clause
  - Corporate continuations
  - Expansion of permanent establishment concept to service providers
  - Adjustments for departure tax on emigration
  - Enhancement on exchange of information provisions

# Highlights of the Protocol



- Impact to
  - Taxpayers resident in Canada or the U.S. making interest payments to residents of the other country
  - Taxpayers that have cross-border structures involving hybrid entities
  - Employers, employees, and service providers working in a cross-border context

# Withholding Tax Elimination



- Cross-border interest payments to an ***unrelated*** party
  - Effective two months after protocol enters into force
    - Later of ratification by each country and January 1, 2008
- Cross-border guarantee fees eliminated
- Cross-border interest payments to a ***related*** party
  - Three calendar year phase-in starting March 1, 2008
    - 7%
    - 4%
    - 0%

# Withholding Tax Elimination



- Not extended to all forms of interest
  - Contingent interest not qualifying as portfolio interest
  - Participating interest arising in Canada such as receipts, sales, income, profits, or other cash flow of the debtor
    - Effectively treated as dividends
    - Subject to 15% withholding rate
  - Interest exceeding arm's length rate

# Withholding Tax Elimination



- Impact of Change
  - Reduce borrowing costs and improve the efficiency of cross-border investments
  - Provide tax savings for U.S. lenders and fosters greater participation by Canadian borrowers in the U.S. capital market
- Considerations
  - Amend Intercompany agreements
  - Terms of outstanding obligations may need to be renegotiated
  - New loan structuring

# Fiscally Transparent Entities



- U.S. resident members of a limited liability company (LLC) can claim treaty benefits
- LLC income treated as earned directly by U.S. resident
  - U.S. treatment
    - U.S. LLC is transparent under U.S. law
    - Members (shareholders) pay U.S. tax
  - Canadian treatment
    - Canada treats LLC as a corporation
    - LLC is subject to Canadian tax
    - In U.S., the entity is not liable for tax

# Fiscally Transparent Entities



- Reduced dividend withholding rate
  - 5% versus 15%
  - Owns 10% of voting stock
- Reduced “branch tax” rate of 5% to repatriated earnings of Canadian branch of LLC
- Effective for tax years beginning on or after January 1, 2009

# Fiscally Transparent Entities



- Denial of treaty benefits to certain hybrid entities
  - Two categories of hybrid entities
    - Reverse Hybrid
    - Unlimited liability company (ULC)
  - Effective on the first day of the third calendar year that ends after the Protocol is in force (January 1, 2010)
  - Give taxpayers a chance to restructure agreements
- Considerations
  - Review cross-border plans that use hybrid entities
  - Tax filing requirements for LLC members in Canada

# Binding Arbitration Process



- Mandatory arbitration on unresolved competent authority cases
  - “Baseball” arbitration approach
    - Must adopt one of the resolutions
    - No jurisdiction for own settlement
- Three-person arbitration panel
  - Representative from Canada and U.S.
  - 3<sup>rd</sup> representative selected by each representative
- Applies to cases filed before or after protocol comes into force

# Binding Arbitration Process



- Arbitration applies to
  - Residence of individuals
  - Permanent establishments (PE)
  - Business profits
  - Related Persons
  - Royalties payable between related parties and determination if taxable or exempt
  - Other issues that competent authorities decide upon, on an adhoc basis

## Binding Arbitration Process



- Taxpayer has effective veto
  - Agrees not to disclose any information during process other than outcome
- Taxpayer not required to accept outcome
  - May seek alternative resolution in home jurisdiction
- Arbitration procedure outlined in Annex A to the Treaty

# Binding Arbitration Process



- Impact of change
  - May induce competent authorities to reach a negotiated settlement earlier
  - Should result in resolution of competent authority cases within three years or less
  - Effective when Protocol comes into force
- Considerations
  - Transfer pricing
    - Irreconcilable methodologies by Canadian and U.S. authorities

# Pension Provisions



- Applies to individuals who
  - Reside in one country (the “residence country”) and work in the other
  - Contribute to a qualifying retirement plan in the country where they work
- May deduct contributions for residence country tax purposes
- Accruing benefits are not taxable

# Pension Provisions



- Applies to individuals who
  - Move from one country to the other country (the “source company”) for
  - Short-term (up to five years) work assignments and
  - Continue to contribute to a qualifying retirement plan in the first country
- May deduct, for source country tax purposes, contributions for up to five years
- Accruing benefits are not taxable

# Pension Provisions



- Impact of change
  - Tax relief available only to extent it would be in country where qualifying retirement plan is situated
  - Apply for taxation years that begin after the calendar year in which the amendments come into force
- Considerations
  - Expatriate and Inpatriate tax equalization and filings

# Stock Option Benefits



- Provides for sourcing between two countries where
  - Stock option was granted in one country
  - Exercised or disposed after moving to the other country
- Considered to be derived in Canada or U.S. in proportion to
  - Number of days principal place of employment was in Canada or U.S.
  - During the period between the date of grant and the date of exercise or disposition
- Over
  - Number of days in that period
- Outlined in Annex B to the Treaty

# Stock Option Benefits



- Not applied if competent authorities agree option grant is a transfer of ownership
  - Options granted are in the money
  - Options have a short vesting period
- Impact of Change
  - Provides clarity on option benefits
  - Makes cross-border employment opportunities more viable
- Consideration
  - 123R computation
  - Tax adjustment

## Summary



- Elimination of withholding tax on interest will create opportunities for borrowers and lenders in both countries
- New rules on hybrid entities could have significant consequences for existing cross-border structures and proposed transactions
- Binding arbitration will provide relief from double taxation from unresolved issues in competent authority
- New rules on pension benefits facilitate movement of personnel between the two countries
- New rule on sourcing of stock option benefits ensures double taxation will not arise