

New Protocol to the Canada-US Tax Treaty: Binding Arbitration

Most, if not all, of Canada's tax treaties provide a mechanism for taxpayers to seek relief from double taxation when the tax authorities in each of the treaty jurisdictions seek to tax the same income or adopt mutually inconsistent positions relating to the taxation of the taxpayer. Generally, under such circumstances, a taxpayer is required to submit a request to the tax authority in his or her home jurisdiction (the so-called "competent authority"), that then seeks to negotiate a fair resolution of the double taxation issue with the competent authority in the other state. However, the taxpayer is left to bear the risk of excessive taxation if the two competent authorities cannot agree on a settlement.

In a first for the Canadian tax treaty network, the recently released Fifth Protocol (the "**Protocol**") to the *Canada-US Income Tax Convention* (the "**Treaty**") adds a binding arbitration mechanism to the Treaty. Binding arbitration will come into play where the Canadian and US competent authorities have been unable to agree on the settlement of certain double taxation issues. In that case, within two years from the date the competent authorities received the necessary information to commence their review of a double taxation dispute (or such other date that the competent authorities have previously agreed upon), the dispute will be referred to an arbitration panel comprised of a representative selected by each of Canada and the US, and a third selected by each of the representatives.

Not all double taxation disputes are eligible for settlement by binding arbitration. In a diplomatic note to the Protocol, Canada and the US have agreed that disputes relating to: (i) the residence of individuals; (ii) permanent establishments; (iii) business profits; (iv) related persons; and (vi) royalties payable between related persons and the determination of whether royalties are taxable or exempt under the Treaty, will be eligible for resolution under the arbitration provision. Disputes relating to matters not listed in the diplomatic note may also be settled by binding arbitration, but only if both Canada and the US agree the issue is suitable for settlement by arbitration. Unfortunately, a matter that otherwise qualifies for

arbitration will not be submitted to arbitration if both Canada and the US agree, before the date on which arbitration would otherwise commence, that the issue is not suitable for arbitration. Although this provision can result in a taxpayer not obtaining relief from the imposition of double taxation, it can only be invoked through the agreement of both countries, and does not allow one country to avoid arbitration where it has a weak case.

The competent authority of each country is required to submit to the arbitration board its proposed resolution of the double taxation issue and the arbitration board must adopt a resolution put forward by one of the competent authorities. The arbitration board has no jurisdiction to fashion its own settlement or to “split the case down the middle”.

The taxpayer has an effective veto over any arbitration, as it will not commence unless the taxpayer agrees not to disclose any information received during the course of the arbitration, other than its outcome. Also, the taxpayer is not required to accept the outcome of the arbitration, but may seek an alternative resolution through the courts in its home jurisdiction. If the outcome of the arbitration is accepted by the taxpayer, it is binding on both tax authorities.

This mandatory arbitration provision will provide welcome relief to taxpayers ensnared in transfer pricing disputes where the Canadian and US tax authorities have sometimes adopted irreconcilable methodologies for determining the appropriate transfer price.

A Cautionary Note

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

ABOUT McMILLAN LLP'S TAX LAW GROUP

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