

Fifth Protocol to Canada-US Tax Treaty - In Force

The Fifth Protocol (the “Protocol”) to the *Canada-US Income Tax Convention* (the “Treaty”) which was signed on September 21, 2007, came into force on December 15, 2008. The Protocol makes substantial changes to the Treaty; however, not all of the Protocol’s measures come into effect at the same time. The following is a brief summary of the Protocol’s significant changes to the Treaty with a focus on the effective dates of those changes.

Withholding Tax on Cross-Border Payments

Non-Participating Interest

Amendments to the *Income Tax Act* (Canada) eliminated withholding tax on non-participating interest payments made to arm’s length non-residents of Canada as of January 1, 2008. With the coming into force of the Protocol, payments to non-arm’s length US lenders will be eligible for reduced Canadian withholding tax rates on a phased-in basis as set out in the chart below:

Interest Paid In	Maximum Withholding Tax Rate on Non-Arm’s Length Interest
2008	7%
2009	4%
2010 and subsequent years	0%

Participating Interest

Starting February 1, 2009, the Canadian withholding tax rate on interest payments made by a Canadian borrower to a US lender is limited by the Protocol to a rate of 15%, where the interest is determined with reference to (i) receipts, sales, income, profits or other cash flow of the borrower or a related person, (ii) any change in the value of any property of the borrower or a related person, or (iii) any dividend, partnership distribution or similar payment made by the borrower or a related person.

For additional information on withholding tax on cross-border payments, please visit: http://www.mcmillan.ca/Upload/Publication/WithholdingTax_Cross-BorderPayments_1007.pdf.

LLCs

Prior to the enactment of the Protocol, the Canada Revenue Agency’s view was that US LLCs were not entitled to Treaty benefits. After 2008, US LLCs will generally be entitled to Treaty benefits.

For additional information on the recognition of LLCs for Treaty purposes, please visit: http://www.mcmillan.ca/Upload/Publication/Recognition_LLCS_1007.pdf.

Loss of Treaty Benefits for Certain Hybrid Entities

The Protocol's additions to the residence article of the Treaty effectively provide that certain hybrid entities such as unlimited liability companies ("ULCs") will no longer be entitled to claim the benefits of the Treaty. The new hybrid entity amendments come into effect on January 1, 2010.

For additional information on the loss of Treaty benefits for certain hybrid entities, please visit: http://www.mcmillan.ca/Upload/Publication/Recognition_LLCs_1007.pdf.

Limitation on Benefits ("LOB")

Historically, the LOB provision of the Treaty only applied in respect of taxes imposed by the US. With the Protocol now in force, the Treaty contains the first comprehensive LOB clause to limit the Canadian tax benefits otherwise afforded by a Canadian tax treaty. In respect of taxes withheld at source, the amendments to the LOB clause may be applied to disallow the tax benefits for amounts paid or credited on or after February 1, 2009. For all other taxes, the LOB clause will apply to taxation years that begin after December 31, 2008.

For additional information on the limitation of benefits clause, please visit: http://www.mcmillan.ca/Upload/Publication/TreatyShopping_1007.pdf.

"Permanent Establishment" for Service Providers

The Protocol adds a new section to the definition of "permanent establishment" which deals with service enterprises. The expanded definition of "permanent establishment" will mean that in certain circumstances, the activities of cross-border service providers will constitute a "permanent establishment" even though the service provider does not operate from a fixed place of business.

The new definition of "permanent establishment" comes into effect for the third taxation year of an enterprise that ends after December 15, 2008.

For additional information on "permanent establishment", please visit: http://www.mcmillan.ca/Upload/Publication/PermanentEstablishment_1007.pdf.

Taxpayer Emigration

A new rule in the Protocol, aimed at preventing double taxation of pre-emigration gains on property held by an emigrant, allows individuals who are subject to the "departure tax" in respect of the deemed disposition of certain assets to opt to be treated in their new country of residence as having disposed of and reacquired the property for fair market value proceeds at the time of the change in residence. This rule applies to any emigrations between Canada and the US after September 17, 2000.

For additional information on taxpayer emigration, please visit: http://www.mcmillan.ca/Upload/Publication/TaxpayerEmigration_1007.pdf.

Trans-Border Pension Provisions

Before the Protocol came into force, relief for individuals who had cross-border work assignments and who were covered by a qualified retirement plan, was limited to an election to defer tax on income accrued in a plan in the other country until the plan made a distribution. The election did not extend to contributions or accrued benefits under a retirement plan. The Protocol addresses these deficiencies with new provisions that specifically apply to plan contributions and benefit accruals. The pension provisions come into effect on January 1, 2009.

For more information on the impact of the Protocol on trans-border pension provisions, please see: http://www.mcmillan.ca/Upload/Publication/Trans-BorderPensionProvisions_1007.pdf.

Stock Option Apportionment Rules

To eliminate double taxation under the Treaty, Annex B to the Protocol provides a new apportionment rule that applies to situations where an employee is granted a stock option in one country and exercises the option in the other country while employed by the same (or a related) employer. The apportionment rule came into effect on December 15, 2008.

For more information on the stock option apportionment rules, please visit: http://www.mcmillan.ca/Upload/Publication/Trans-BorderPensionProvisions_1007.pdf.

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.

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Our Tax Law Group ranks among the best in Canada and includes individuals who have been recognized internationally as leading advisers in The Martindale-Hubbell Legal Directory and The Canadian Legal LEXPERT Directory. Always sensitive to our clients' business objectives, we provide comprehensive and pragmatic Canadian tax advice on a wide variety of matters, including corporate reorganizations, mergers and acquisitions, securities, structured financing and derivative products, leasing, and cross-border transactions. Routinely advising clients on compliance matters, we are experienced in negotiating disputes with revenue authorities and litigating tax issues.

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