

**New Protocol to the Canada-US Tax Treaty: Withholding Tax on Cross-Border Payments**

Canada and the United States signed the widely anticipated Fifth Protocol (the “**Protocol**”) to the *Canada-US Income Tax Convention* (the “**Treaty**”) on September 21, 2007. The Protocol will enter into force once it has been ratified by both the Canadian and United States governments. The Government of Canada intends to proceed with a Bill to ratify the Protocol at the earliest opportunity. The earliest date on which the Protocol could enter into force is January 1, 2008. This would require both countries to ratify the Protocol in 2007, which is thought to be unlikely.

This bulletin discusses certain changes introduced by the Protocol pertaining to withholding taxes on cross-border payments.

**Non-Participating Interest**

Once it has been ratified by both countries, the Protocol will generally eliminate withholding tax on conventional interest payments made by Canadian taxpayers to US residents. Draft amendments to the *Income Tax Act* (Canada) (the “**Tax Act**”) have also been introduced by the Canadian Minister of Finance that will serve to eliminate the withholding tax on interest paid to all arm’s length non-residents, regardless of their country of residence, once the elimination of withholding tax on interest payments made between residents of Canada and the US under the Treaty takes effect.

The current Treaty provides that US lenders who are entitled to the benefits of the Treaty are generally required to pay a withholding tax of 10% on interest payments received from Canadian resident borrowers. This amount is withheld by the Canadian borrower and remitted to the Canada Revenue Agency (the “**CRA**”) on the lender’s behalf. Under the new regime introduced by the Protocol, withholding tax on interest payments between arm’s length residents of Canada and the US will generally be eliminated as of the second month after the Protocol enters into force. Withholding taxes on interest payments between non-arm’s length residents will be phased out over a three-year period.

<b>Time Following Entry into Force of Protocol</b>	<b>Maximum Withholding Tax Rate on Non-Arm’s Length Interest</b>	<b>Maximum Withholding Tax Rate on Arm’s Length Interest</b>
Prior to Second Month	10%	10%
First Year	7%	0%
Second Year	4%	0%
Third and Subsequent Years	0%	0%

Where a “special relationship” exists between the lender and borrower, the withholding tax rates outlined above will not apply in respect of any interest paid in excess of the amount that would have been paid in the absence of the special relationship.

The elimination of withholding tax on interest payments is a welcome change for both US resident lenders and Canadian borrowers. Canadian borrowers will particularly benefit where a withholding tax exemption would not otherwise have been available because they will no longer face demands to “gross-up” interest payments to compensate for the imposition of withholding tax. Even if a withholding tax exemption, such as the exemption on certain long-term loans, were otherwise available, the proposed changes will reduce transaction costs as the need for additional documentation and structuring to fit within the applicable withholding tax exemption will be eliminated.

Canadian lenders may lose some of their competitive advantage as a result of the proposed changes, since it will be less costly for Canadian borrowers to borrow from US resident lenders. However, Canadian lenders will continue to have a different, and perhaps preferable, risk profile vis-à-vis their US resident counterparts; for example, Canadian lenders will not have to manage certain foreign market risk factors or foreign currency fluctuation risks that a non-resident lender may have to manage.

#### *Current Transactions/Existing Agreements*

Until the second month after the Protocol enters into force, withholding tax on interest payments to US resident borrowers will still be required to be withheld and remitted unless a withholding tax exemption is available. As a result, parties to existing agreements may wish to negotiate the deferral of interest payments to a period where the withholding tax rate is reduced or eliminated. Such a deferral should be discussed with a tax advisor before being implemented as negative tax consequences can arise, particularly where the parties are not at arm’s length. For example, in highly simplified terms, the Tax Act provides that, in a non-arm’s length context, if an amount of interest is unpaid at the end of the second taxation year following the year in which the

interest expense was incurred, the amount will generally be included in the Canadian borrower’s income in the third taxation year following the taxation year in which the interest expense was incurred.

Currently, Canadian corporate borrowers (and Canadian partnerships, where all of the partners are Canadian resident corporations) and arm’s length non-resident lenders often rely on relief provided by the long-term debt withholding tax exemption under sub-paragraph 212(1)(b)(vii) of the Tax Act. To qualify for the exemption, the Canadian corporate borrower must deal at arm’s length with the lender. In addition, under the terms of the operative loan agreement, the borrower must not be obliged to repay more than 25% of the principal amount borrowed within the first 5 years of the agreement, absent an event of default (certain exceptions apply). If enacted, a proposed amendment to the Tax Act released by the Department of Finance on October 2, 2007 will allow for repayment of more than 25% of the principal amount of a debt obligation within 5 years of the date of issue in the event that a change to the Tax Act or a tax treaty has the effect of relieving the non-resident lender from liability for tax in respect of interest on the relevant debt. The change, if enacted, will apply to agreements entered into on or after March 19, 2007.

#### **Participating Interest**

Canadian withholding tax on interest payments made by a Canadian borrower will not be eliminated under the Protocol, but will be limited 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.<sup>1</sup>

<sup>1</sup> Currently, the official reference in the Protocol in respect of (iii) is “any dividend, partnership distribution or similar payment made by the borrower to a related person” (which suggests that interest determined by reference to dividends on widely held shares would generally be subject to the non-participating interest withholding tax rates discussed above); however, we understand that the Department of Finance is of the view that the reference was intended to read “any dividend, partnership distribution or similar payment made by the borrower or a related person” and that steps will be taken to amend the language accordingly.

US withholding tax on interest payments made by a US borrower is not eliminated under the Protocol, but will be limited to a rate of 15%, where the interest is contingent interest of a type that does not qualify as portfolio interest under US law.

### Guarantee Fees

In many cases, borrowings are effected by the parent of a corporate group which, in turn, advances all or a portion of the borrowed funds to certain subsidiaries by various means. Under such circumstances, it is common for lenders to request that each member of the corporate group guarantee the payment of all amounts under the operative debt obligations. Difficult tax issues can potentially arise where a guarantor resides outside the borrower's taxing jurisdiction and the Canada-US context is no exception.

While many tax issues relating to cross-border guarantees of indebtedness will remain, the Protocol generally eliminates withholding tax on payments made between residents of Canada and the US in respect of the provision of such guarantees.

### Dividends

Under the current Treaty, the withholding tax rate on dividend payments is reduced from 15% to 5% where the beneficial owner of the dividend is a company that owns at least 10% of the voting shares of the company paying the dividend. The Protocol clarifies that a company will be considered to own the voting shares owned by "an entity that is considered fiscally transparent" and is not resident in the country of which the payor is resident, in proportion to the company's interest in the transparent entity. Accordingly, upon

the enactment of the Protocol, a Canadian corporation paying a dividend to an LLC that is considered to be fiscally transparent may generally look through the LLC to determine the appropriate dividend withholding tax rate.

Traditionally, the CRA has been of the view that dividends paid by a Canadian corporation to a US partnership with Treaty resident partners will be subject to the 15% withholding tax rate (regardless of the proportionate partnership interest, of the US corporate partners). This position is based on the view that Canadian partnership law does not recognize that a particular corporate partner owns an identifiable portion of a partnership's property. However, the new dividend withholding tax rules should apply to a Canadian company paying a dividend to a partnership with a US corporate partner. While it is well established in Canadian jurisprudence that a partnership is not a distinct legal entity (which raises the question whether the CRA will view a partnership that receives a dividend as "an *entity* that is considered fiscally transparent"), a partnership is referred to as an entity in a number of provisions in the Tax Act.

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Any future tax planning designed to take advantage of the reduced withholding tax rates introduced by the Protocol must take into account, among other things, the limitation on benefits provision introduced in the Protocol and the general anti-avoidance rule in the Tax Act. The structuring and restructuring of cross-border transactions, more than ever, is replete with pitfalls and opportunities and, therefore, careful tax planning is essential.

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### 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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