

Canada

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Canada-US tax treaty

On December 14 2007, the fifth Protocol to the Canada-US Income Tax Convention (the Treaty) was ratified by Canada when Bill S-2 received royal assent. The US has yet to complete its ratification process and the Protocol will enter into force once it has been ratified by the US (and Canada has been notified). In addition, the draft legislation to amend the Income Tax Act (Canada) (the Tax Act) introduced by the Minister of Finance this past October (the Proposals) received royal assent on December 14 2007.

Withholding tax on interest payments

As a result of the Proposals receiving royal assent, the exemption from withholding tax on interest paid to arm's-length non-residents, regardless of their country of residence, became effective as of January 1 2008. For a detailed discussion of this amendment to the Tax Act, refer to the firm's December 2007 Structured Finance Update. However, the phase out of Canadian withholding tax on interest payments made to a related US resident, as proposed by the Protocol, will only be effective following the entry into force of the Protocol. The rate of withholding on interest paid to related US residents will be reduced to 7% for the calendar year in which the Protocol enters into force; 4% for the following calendar year and will be eliminated for subsequent years.

Limited Liability Companies

As discussed in our November 2007 M&A Update, the Protocol will extend Treaty benefits, such as the reduced withholding tax rates and the exemption for capital gains in certain circumstances, to US limited liability companies (LLCs). The Protocol extends Treaty benefits to LLCs by permitting each member of an LLC to obtain the applicable Treaty relief on the income that is considered to be derived by each such member, provided that the member is a resident of the US, is entitled to Treaty benefits and meets certain other conditions. Accordingly, US residents who earn income or gains through LLCs will be entitled to the applicable reduced withholding tax rates or exemptions set out in the Treaty where the US treatment of the income or

gains earned through the LLC is identical to what would have been the treatment if the income had been earned directly by the US resident.

Unlimited Liability Companies

Although the Protocol provides for the extension of Treaty benefits to LLCs, it also proposes to deny Treaty benefits for other types of hybrid entities in two new rules. The first rule denies Treaty benefits in situations where a resident of one country derives or receives income, profits or gains through a hybrid entity that is treated as a separate entity in that resident's country, but is fiscally transparent under the laws of the source country. This rule is aimed at eliminating Treaty benefits for structures such as "synthetic NRO" financing structures that use a "reverse hybrid" partnership to finance Canadian operations. It may be possible to avoid the adverse effects of this rule by inserting another entity into the structure that is resident in another jurisdiction with which Canada has entered into an income tax treaty.

The second rule denies Treaty benefits in cases where a payment is made to a resident of one country from a hybrid entity that is fiscally transparent under the laws of the resident's country, but is treated as a separate entity in the source country. This rule would appear to deny Treaty benefits on amounts received by US residents from Canadian Unlimited Liability Companies (ULCs) that are treated as fiscally transparent for US tax purposes. For example, where a US corporation forms a ULC to carry on its Canadian operations, the ULC would be treated as a Canadian corporation for Canadian tax purposes, but may be considered a Canadian branch for US tax purposes. The Protocol would deny the reduced withholding tax rates to payments such as interest, royalties and dividends made by the Canadian ULC to the US parent, and such payments would be subject to the full rate of withholding tax of 25%. In the case of dividends paid by the ULC, the full rate of withholding would apply even though the income of the ULC is generally fully taxable in the US. The application of this rule to these types of payments was unexpected. The US is drafting the Technical Explanation to the Protocol, which may provide clarification as to the intended application of this second rule. In order to afford residents of the two jurisdictions time to adjust to these changes, the Protocol provides that both rules will not be effective until the first day

of the third calendar year that ends after the Protocol enters into force. Once again, it may be possible to avoid the adverse effects of this rule by inserting an entity resident in another treaty jurisdiction (including Luxembourg and Barbados) above the ULC.

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