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United States and Canada Sign the Fifth Protocol to the U.S.–Canada Income Tax Treaty

Background

On September 21, 2007, U.S. and Canadian officials signed the Fifth Protocol ("Protocol") to the U.S.–Canada Income Tax Treaty ("Treaty") that entered into force on August 16, 1984. The Protocol makes significant amendments to various Treaty articles, most notably Article IV (Residence), Article V (Permanent Establishment), Article XI (Interest), Article XXVI (Mutual Agreement Procedure), and Article XXIXA (Limitation on Benefits). The Protocol will become effective once it is ratified by the U.S. Senate and Canadian Parliament, but not before January 1, 2008, with some provisions taking effect later.

Overview

Article IV (Residence)

The Canadian tax authorities have historically maintained that U.S. limited liability companies ("LLCs") are not "residents" for treaty purposes since they are not liable to tax in the United States absent an election to be treated as a corporation. The Protocol amends Article IV (Residence) by extending Treaty benefits to certain fiscally transparent entities, including LLCs. The Protocol provides that an amount of income, profit or gain will be deemed derived by a resident of a contracting state if (i) the person is considered under the laws of that state to have derived the amount through an entity and (ii) the tax treatment in the state of residence of the amount received is the same as if the person had directly received it, by reason of the entity being fiscally transparent. This means that a U.S. resident who receives income from Canadian sources through an LLC will receive the same Treaty benefit as if he had received the income from Canada directly. It is not clear whether the Canadian tax returns with respect to the income from Canadian sources should be filed by the U.S. resident or by the LLC — the LLC is treated as transparent but for Canadian purposes it is still viewed as a corporation. Further guidance is needed in this regard.

In a surprise move, the Protocol limits the availability of Treaty benefits in the case of certain hybrid and reverse hybrid entities. First, under paragraph 7(a), an amount of income, profit or gain will not be considered to be derived by a resident of one country, e.g., the United States, if the other country, e.g., Canada, considers the person to have derived the income through an entity not treated as a resident of the United States, if, by reason of the entity being treated as a corporation in the United States, treatment of the amount under U.S. tax laws is not the same as its treatment would be if that amount had been derived directly by that person. This provision is likely to affect transactions in which, for example, interest is paid to a U.S. person by a Canadian limited partnership that is transparent for Canadian purposes but is treated as a corporation for U.S. tax purposes ("reverse hybrid").

Second, under paragraph 7(b), an amount of income, profit or gain will not be considered to be derived by a resident of one country, e.g., the United States, if the other country, e.g., Canada, considers the person to have derived the income from a resident of Canada, if, by reason of the entity being treated as fiscally transparent in the United States, the treatment of the amount under U.S. tax laws is not the same as its treatment would be if that entity were not treated as fiscally transparent under U.S. laws. This provision is likely to affect U.S. corporations carrying on business in Canada through unlimited liability companies (such as Nova Scotia unlimited liability companies or Alberta unlimited liability companies), which are treated as corporations for Canadian tax purposes but are checked to be transparent for U.S. tax purposes ("hybrids"). Similarly, paragraph 7(b) is likely to affect a Canadian resident that receives an amount from a U.S. entity that is treated as a corporation for U.S. tax purposes but is a disregarded entity for Canadian purposes ("domestic reverse hybrid").

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Article V (Permanent Establishment)

The Protocol also amends Article V (Permanent Establishment), largely to the benefit of Canada, which had unsuccessfully tried to tax a U.S. consultant providing services in Canada at a client's premises on the grounds that the consultant had a fixed base in Canada. Pursuant to the amendment, an enterprise of one of the contracting states will be deemed to have a permanent establishment in the other contracting state where (i) the services are performed in that other contracting state by an individual present in that other contracting state for 183 days or more in any 12-month period and, during that time, more than 50 percent of the gross active business revenues of the enterprise consist of income derived from services performed by that individual in that other contracting state, or (ii) the services are provided in that other contracting state for 183 days or more in any 12-month period with respect to the same project or a connected project for customers who are residents of that other contracting state or have a permanent establishment in that other state.

Article XI (Interest)

The amendment to Article XI (Interest) eliminates the 10 percent withholding tax on cross-border interest payments and provides for no withholding tax. For arm's length interest payments, the withholding tax is eliminated as of the second month after the Protocol enters into force. For non arm's length interest payments, the withholding tax is gradually reduced (to 7 percent in year one and to 4 percent in year two) before it is eliminated in year three after the Protocol is entered into force. This provision is largely favorable for the United States as it opens up the Canadian markets to U.S. lenders and will allow U.S. lenders to receive interest payments free of Canadian tax.

The article also addresses guarantee fees and provides that guarantee fees will not be subject to withholding tax after the Protocol enters into force. In addition, the article provides that the withholding tax exemption does not apply to participating interest and such interest is subject to withholding tax at the rate of 15 percent.

Article XXVI (Mutual Agreement Procedure)

The amendment in the Protocol to Article XXVI (Mutual Agreement Procedure) is also significant as it requires arbitration where the competent authorities of the United States and Canada have endeavored but are unable to reach a complete agreement in a particular case. If the parties accept the determination of the arbitration board, the decision will be binding on both countries with respect to the case. Similar provisions are included in the U.S.–Germany and the U.S.–Belgium agreements just signed by the U.S. Senate.

Article XXIXA (Limitation on Benefits)

The Protocol also amends Article XXIXA (Limitation on Benefits). The current limitation on benefits article, by its terms, is only for purposes of the application of the Treaty by the United States. When the current limitation on benefits article was added in the third protocol to the Treaty, Canada did not seek its application for its own use and sought to rely on its own domestic anti-abuse rules, such as the general anti-avoidance rule, to curb treaty shopping. However, curbing treaty shopping using the general anti-avoidance rule has proved problematic for the Canadian tax authorities and Canada sought to extend the limitation on benefits article for its own use as well. As a result, the current Protocol provides that the article applies for the purposes of the application of the Treaty by either the United States or Canada.

Conclusion

A number of the changes to the Treaty are significant and some are more taxpayer friendly than others. As a result, taxpayers should carefully review their cross-border business activities and financing structures in light of these changes.

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