

TAX ALERT

U.S. AND CANADA SIGN PROTOCOL TO INCOME TAX TREATY



On September 21, 2007, the governments of the United States and Canada signed a protocol (the Protocol) to the income tax treaty currently in effect between those two countries (the Existing Treaty). The Protocol, which still has to be ratified by the U.S. Senate and the Canadian Parliament, would amend certain key provisions of the Existing Treaty. The following are some of the highlights of the changes made by the Protocol.

Hybrid Entities. The Existing Treaty does not include specific provisions dealing with entities (such as limited liability companies, or LLCs) which are treated as pass-through entities under the tax laws of one country but as taxable entities under the tax laws of the other (i.e., hybrid entities). The Canadian taxing authorities have interpreted the Existing Treaty to mean that a U.S. LLC is not entitled to claim treaty benefits in its own right (since it does not pay tax and hence is not a “U.S. resident,” as defined under the treaty); moreover, it has taken the position that U.S. members of such an LLC are also not entitled to claim treaty benefits, since, under Canadian law, the LLC is not a pass-through entity. The result of this position is that U.S. persons who derive income from Canada through an LLC are not entitled to treaty benefits, even though they would have been entitled to the benefits if they had derived the income directly.

The Protocol fixes this problem by adopting a rule for hybrid entities that generally tests the availability of treaty benefits based on whether the person claiming treaty benefits is, under the tax laws of his *home* country, taxed in the same way as if the income were derived directly by that person. Thus, for example, where a U.S. person derives income from Canada through an LLC (or other hybrid entity), he is entitled to treaty benefits (assuming that he qualifies for such benefits in his own right), since, under *U.S.* law, he is taxable on his share of the LLC’s income in the same manner as though he derived the income directly from Canada. An exception is provided where the hybrid entity is itself a resident of the *source* country; thus, in the example, if instead of a U.S. LLC the U.S. taxpayer derived income through a Canadian entity that checks the box to be treated as a pass-through for U.S. tax purposes, the treaty would not limit Canada’s ability to tax the income.

The approach of looking to the laws of a taxpayer’s home country to determine whether treaty availability should be tested at the entity level or the shareholder/member level is generally consistent with the approach that U.S. law applies in interpreting treaties.

Withholding Tax on Interest. The Protocol would eliminate withholding tax on interest (which, under the Existing Treaty, can generally be taxed at a rate of 10 percent). An exception is provided for contingent interest, which is instead subject to the Treaty rules applicable to dividends (discussed below).

Thus, if U.S.-source interest does not qualify for the portfolio interest exemption under U.S. law because it is contingent, the U.S. can levy a withholding tax of 5 percent or 15 percent (depending on the recipient's level of ownership in the payor entity) under the dividend provisions of the Treaty. On the other hand, if the interest is not contingent but fails to qualify for the portfolio interest exemption for another reason (for example, because the recipient is a 10 percent owner of the payor or because it is derived by a bank on a loan made in the ordinary course of its business), the interest would be exempt from U.S. withholding tax under the Protocol.

Withholding Tax on Dividends. The Protocol does *not* follow the example of some other recent treaties, which have eliminated withholding tax on dividends. Instead, it generally retains the rule of the Existing Treaty under which dividends can be taxed at a rate of 15 percent (or 5 percent in the case of dividends paid to a 10 percent owner). The Protocol does add a rule which provides that, where dividends are received through a pass-through entity (as determined under the laws of the home country), other than an entity which is a resident of the source country, the 10 percent ownership threshold for the lower rate is applied at the level of the taxpayer claiming treaty benefits, rather than the level of the entity. For example, assume A and B are both U.S. residents and each owns 50 percent of an LLC that owns 12 percent of the stock of a Canadian corporation. Dividends paid by that corporation would be subject to tax at a rate of 15 percent, since neither A nor B indirectly owns at least 10 percent of the payor corporation's stock. On the other hand, if A owned 90 percent and B owned 10 percent of the LLC, 90 percent (A's share) of the dividends would qualify for the 5 percent rate, since A's indirect ownership of the payor corporation would be 10.8 percent.

The Protocol also expands the circumstances under which the 15 percent rate is available to dividends paid by a U.S. real estate investment trust (REIT). Under the Existing Treaty, this rate is only available to *individuals* who own not more than 10 percent of the REIT's stock. (Note that the 5 percent rate is not available for dividends paid by REITs; this is not changed by the Protocol). The Protocol would provide, in addition, that the 15 percent rate would be available for dividends paid to (i) holders of not more than 5 percent of a publicly traded class of REIT stock, and (ii) holders of not more than 10 percent of the stock of a REIT that is diversified.

Limitation on Benefits. The Existing Treaty, like most U.S. treaties since 1980, contains a "limitation benefits" (LOB) provision that is designed to preclude "treaty-shopping." Under the Existing Treaty, the LOB provision only applies to Canadian residents claiming exemption from, or a reduced rate of, taxation by the United States. The Protocol extends the LOB rules to U.S. residents claiming the benefits of the treaty to reduce Canadian tax.

The Protocol also made some changes to the way the LOB rules operate. Under the LOB provision, even if a person is a "resident" of a treaty country, he is only entitled to the benefits of the Treaty if he meets one of several alternative tests. Certain of these tests (which generally apply to persons other than individuals) require that at least 50 percent of the person's ownership interests be held by persons who themselves are residents of specified countries. Under the Existing Treaty, this 50 percent ownership threshold must be satisfied by looking to both overall voting power and overall value. The Protocol tightens these rules by requiring, in addition, that the 50 percent ownership test also be satisfied with respect to both the voting power and value of any class of stock or other ownership interest that disproportionately shares in the earnings of the entity.

Pensions. The Protocol adds new rules to the Existing Treaty concerning the deductibility of employee (and in some cases, employer) contributions to retirement plans. The new rules generally apply under the circumstances described below.

First, the new rules apply to individuals who reside in one country and work in the other country (i.e., cross-border commuters) and who contribute to a retirement plan in the country where they work. Under the Protocol, provided that certain conditions are satisfied, the contributions such commuters make to a retirement plan in the country where they work may be deducted for tax purposes in their country of residence. For example, assume that a resident of the United States is employed in Canada and contributes to a retirement plan sponsored by his Canadian employer. Under the Protocol, the employee's contributions to the Canadian employer's retirement plan are deductible for U.S. tax purposes (subject to U.S. limits).

The new rules also apply to individuals who move from their home country to another country for a temporary or short-term work assignment (generally up to five years) and continue to contribute to a retirement plan in their home country. For example, assume that an employee of a Canadian company is assigned to work at the company's U.S. affiliate for four years, and the employee continues to contribute to the retirement plan of the Canadian company. Under the Protocol, provided that certain conditions are satisfied, the contributions made by the employee and the U.S. company to the Canadian company's retirement plan will be deductible by the employee and the U.S. company for U.S. tax purposes.

Since the Protocol clarifies the rules for deductibility of contributions to retirement plans, the addition of the new rules may help facilitate the movement of employees between the U.S. and Canada (e.g., either as cross-border commuters or employees on temporary assignment).

Other Changes. Other changes made by the Protocol include the following:

- *Income attributable to former permanent establishments.* Under the Existing Treaty, a source state's reduced ability to tax certain types of income (such as dividends, interest and royalties) does not apply if the recipient conducts business through a "permanent establishment" in the source state and the income is attributable to such permanent establishment. The Protocol would extend this rule to situations where the recipient formerly had (but no longer has) a permanent establishment, and the income is attributable to such former permanent establishment.
- *Students and Trainees.* The Protocol would narrow the exemption from source-country tax on income of students and trainees.
- *Guarantee fees.* The Protocol would add a specific provision under which a fee received for a guarantee of debt would only be taxable in the recipient's home country (unless attributable to a permanent establishment in the source country).
- *Competent authority.* The Protocol would add more specific rules governing when a dispute that is not resolved by the competent authority procedure would be submitted to arbitration.
- *Exchange of information.* The Protocol would provide somewhat enhanced exchange of information procedures.

Effective Date. The Protocol will “enter into force” on the later of January 1, 2008, or the date on which each government has officially notified the other that it has been ratified. In general, those provisions of the Protocol that affect withholding taxes will apply to amounts paid or credited on or after the first day of the second month that begins after the Protocol enters into force; other provisions apply to tax years that begin after (or, if both countries ratify the Protocol in 2007, tax years that begin in and end after) the calendar year in which the Protocol enters into force.

CONTACT INFORMATION

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