CANADA AND THE U.S. RATIFY SIGNIFICANT TAX TREATY CHANGES

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On December 15, 2008, the Canadian and United States governments announced that the Fifth Protocol (the "**Protocol**") to the *Canada-U.S. Income Tax Convention* (the "**Treaty**") had been fully ratified by both governments and had entered into force. The Protocol will significantly alter the tax treatment of many commercial transactions between residents of the United States and Canada, as well as structures that are commonly employed to effect investments between the two countries. The most significant changes introduced by the Protocol include the elimination of withholding tax on conventional interest payments, the establishment of a reciprocal "limitation on benefits" clause, and new rules governing the treatment of certain hybrid entities.

Withholding Tax on Cross-Border Interest Payments

Under the new regime introduced by the Protocol, withholding tax on non-participating interest payments between arm's length residents of Canada and the U.S. (currently levied at a rate of 10%, where applicable) will generally be eliminated as of the first day of February 1, 2009. Moreover, the Protocol also provides that withholding taxes on non-participating interest payments between non-arm's length residents will be phased out over a three-year period.

Contemporaneous with the release of the Protocol, the Canadian government announced the introduction of statutory amendments that would eliminate withholding tax on non-participating interest payments made to all arm's length non-residents (regardless of their treaty status). These amendments were enacted with an effective date of January 1, 2008.

The "across-the-board" elimination of withholding tax on most interest payments is a welcome development for non-resident lenders wishing to do business with Canadian enterprises. In addition to the possible savings arising from an expanded group of potential funding sources, and the elimination of demands to "gross-up" interest payments to compensate for the imposition of withholding tax, Canadian borrowers should also benefit from reduced transactions costs now that the need for additional documentation and structuring to fit within one of the narrow range of exemptions available under the previous statutory rules (such as the commonly accessed exemption for long-term debt) has been eliminated.

Limitation on Benefits

The Protocol contains a comprehensive "limitation on benefits" clause that will potentially limit the availability of both U.S. and Canadian tax benefits otherwise available under the Treaty (the "Updated LOB Article"). Specifically, the Updated LOB Article provides that the benefits of the Treaty will be restricted to those residents of Canada or the U.S. that either: (i) are "qualifying persons" as defined in the Updated LOB Article; or (ii) satisfy one of three specific tests relating to their establishment, operation, or ownership.

The introduction of the Updated LOB Article marks a notable departure from traditional Canadian tax policy. Historically, the Canadian government has sought to address its treaty abuse-related concerns through the application of statutory anti-avoidance rules. The emergence of the Updated LOB Article may signal the government's desire to include comparable provisions in Canada's other treaties, particularly in light of the restrictive manner in which the Canadian courts have applied statutory anti-avoidance rules in the treaty context.

Recognition of LLCs and the Elimination of Treaty Benefits for Certain Other Hybrid Entities

The Protocol contains several measures respecting certain so-called "hybrid" entities which, depending on the entity and the particular circumstances, may operate to either provide entitlement to (or broaden) Treaty benefits, or eliminate Treaty benefits, in respect of amounts paid by or derived through such entities.

U.S. LLCs

U.S. limited liability companies ("**U.S. LLCs**") are popular business vehicles because of their flexible US tax treatment and the liability protection afforded to their members. However, the longstanding denial of benefits by the Canadian revenue authority to U.S. LLCs and their members under the historical provisions of the Treaty had, in many circumstances, rendered these vehicles inefficient for cross-border use.

The Protocol will extend Treaty benefits to amounts derived through U.S. LLCs by amending the residence provision (Article IV) of the Treaty. In simplified terms, the Protocol provides that a U.S. resident earning income through an entity that is considered to be fiscally transparent for U.S. purposes, such as most U.S. LLCs, will generally be entitled to claim the benefits of the Treaty where the U.S. tax treatment of the income derived through that entity is the same as it would have been had the income been derived directly by the U.S. resident.

These welcome measures shall have effect, for withholding tax purposes, on the first day February 1, 2009 and, for income tax purposes, for taxable years commencing after 2008.

Loss of Treaty Benefits for Certain Other Hybrid Entities

The Protocol will effectively eliminate Treaty benefits in respect of amounts paid by or derived through certain other hybrid entities. These measures, which will not take effect until January 1, 2010[1], are understood to be targeted at perceived abuses stemming from the differing tax treatment of such entities under the Canadian and U.S. tax systems.

Of particular significance, U.S. resident shareholders of a Canadian unlimited liability company (a "ULC"), which "checks-the-box" to be treated as a disregarded entity for U.S. tax purposes, will generally not be entitled to claim the benefits of the Treaty in respect of amounts paid to, or derived by, the U.S. shareholders from the ULC (such as interest and dividends).

Similarly, where a U.S. resident derives an amount through a Canadian partnership and, by reason of the partnership not being treated as fiscally transparent under the laws of the U.S., the U.S. tax treatment of the amount is not the same as it would have been had the amount been derived directly by the U.S. resident, the U.S. resident will not be entitled to claim the benefits of the Treaty in respect of the amount. One practical result of this measure will be to preclude U.S. residents from claiming the Treaty-reduced rates of Canadian withholding tax currently available in respect of payments made in connection with certain "reverse hybrid" structures used by U.S. residents to finance Canadian acquisitions and operations. Whether the benefits of such structures could be viably continued through the interposition of additional entities resident in other Canadian treaty jurisdictions is a question that will no doubt garner much consideration in the months to come.

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In addition to the foregoing matters, the Protocol also introduces a host of additional tax changes, including new rules governing stock options and pension contributions and new mandatory arbitration procedures, which may have a significant impact in the transfer-pricing context.

The Protocol is expected to have dramatic implications for the structuring of investment and capital flows between Canada and the U.S., and may dictate a re-evaluation of many existing structures and the associated "tried and true" planning techniques. At a minimum, entities with cross-border investments and other business activities would be well advised to reassess the tax treatment of such arrangements in light of the potential application of the provisions of the Protocol.

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Endnotes

1 There have been suggestions by certain government representatives that another protocol to the Treaty may be introduced prior to this date in order to narrow the application of these new measures.