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U.S. TAX-EXEMPTS AND ARTICLE XXI OF THE CANADA-U.S. TREATY: CLAIMING AN EXEMPTION FROM CANADIAN WITHHOLDING TAX

Certain amounts, including dividends, that are paid or credited by a Canadian resident to a nonresident of Canada are generally subject to Canadian tax under Part XIII of the Income Tax Act (Canada) (“Act”).¹ Although the ultimate liability for Canadian Part XIII tax (commonly referred to as “withholding tax”) rests with the relevant nonresident, it is the Canadian-resident payor of an amount that is subject to Part XIII tax that generally has the obligation to withhold and remit withholding tax on behalf of the nonresident.

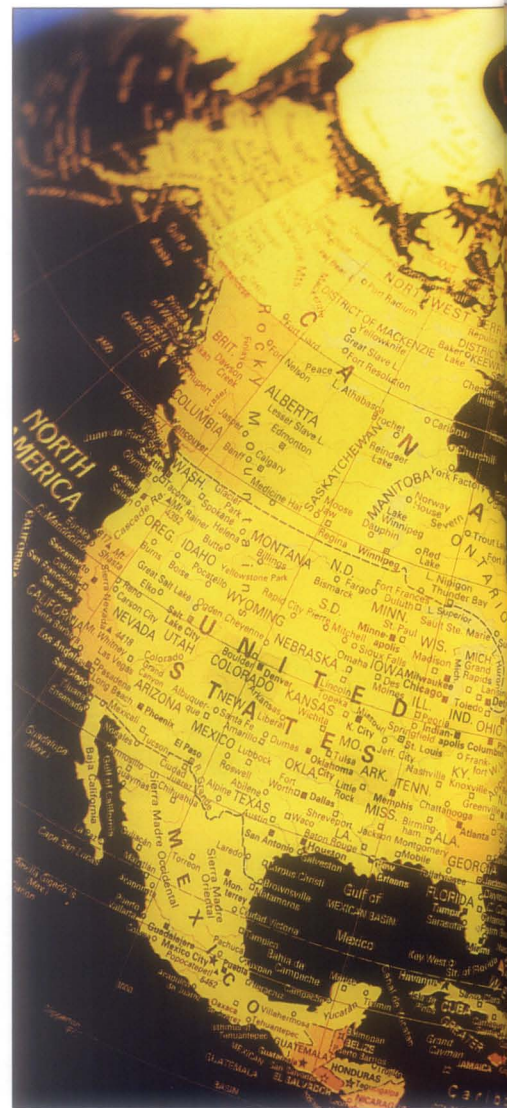
The general withholding tax rate under the Act is 25%, but the applicable rate may be reduced by a bilateral tax treaty. For instance, under the Canada-United States income tax treaty (“Treaty”),² dividends paid by a Canadian corporation to a resident of the

United States may be subject to a materially reduced withholding tax rate.

Article XXI of the Treaty generally provides an exemption (“Exemption”) from Canadian withholding tax in respect of dividends and interest income derived by a trust, company, organization, or other arrangement that is resident in the U.S. for purposes of the Treaty (hereinafter referred to as a “Trust”) if the Trust is generally exempt from income taxation in a tax year in the U.S. and is operated exclusively to do any of the following:

1. Administer or provide pension, retirement, or employee benefits.³
2. Earn income for the benefit of a Trust that is generally exempt from income taxation in a tax year in the U.S. and is operated exclusively for a purpose described in (1) above.⁴
3. Earn income for the benefit of a religious, scientific, literary, educational, or charitable organization

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resident in the U.S. to the extent that it is tax exempt in the U.S.⁵

A Trust that is entitled to claim the benefit of the Exemption, and thereby may be exempt from withholding tax on dividends and interest income that it derives from Canada (“Exempt Trust”), may still be subject to Canadian taxes on the income that it earns from carrying on a trade or business in Canada, or that it receives from certain related persons in Canada.⁶

Claiming the Exemption

A Canadian resident that fails to withhold or remit the requisite withholding tax on payments made to a nonresident is liable for the amount of such withholding tax, plus any applicable interest

or penalties.⁷ Accordingly, Canadian residents that pay dividends to a Trust are generally reluctant to forgo the collection and remittance of withholding tax unless they can conclude that the Trust is entitled to claim the benefit of the Exemption. Historically, many Canadian-resident taxpayers have accepted a letter of exemption issued by the Canada Revenue Agency (CRA) confirming that a Trust is entitled to claim the benefit of the Exemption (“Letter of Exemption”) as adequate proof that withholding tax is not exigible in respect of a particular dividend payment. CRA publication T4016 lists the U.S. organizations operating in Canada that have been approved previously for exemption from withholding tax by the CRA under Treaty Article XXI(1) and (2).⁸

The CRA generally will issue a Letter of Exemption when a Trust has established that it is an Exempt Trust. To apply for a Letter of Exemption, the Trust seeking the benefit of the Exemption must write to the CRA’s International Tax Services Office (ITSO) and provide it with the organization’s charter, articles of incorporation, or similar documentation setting out the Trust’s purpose, and a letter of determination issued by the IRS as to the tax-exempt status of the Trust under the Internal Revenue Code. A Letter of Exemption will expire after three years and may be renewed by sending a letter to the ITSO three months prior to the relevant expiry date, with a notarized statement confirming that there has been no change with respect to the Exempt Trust’s mode of operation or its tax-exempt standing with the IRS. A Trust that wants to claim the benefits of the Exemption should consider obtaining a Letter of Exemption prior to receiving dividend income from Canada.

A Canadian-resident payor that has not received a copy of a Trust’s Letter of Exemption may want to consult CRA publication T4016. It does not appear that CRA publication T4016 lists Exempt Trusts that are entitled to claim the benefits of the Exemption under Article XXI(3) of the Treaty (i.e., Trusts that are exempt from income taxation in the U.S. and are operated exclusively to earn income for the benefit of certain entities that are entitled to the Exemption). In addition, the list of Exempt Trusts is not kept current, so, in certain respects, it is not necessarily determinative of a Trust’s status for purposes of the Treaty.⁹

Conclusion

Canadian residents that pay amounts to nonresidents of Canada should exercise care prior to accepting that the recipient of the payment is entitled to the benefits of the Exemption. While Letters of Exemption may provide some evidence of a Trust’s entitlement to claim the benefits of the Exemption, such status should not invariably be assumed absent additional due diligence. ●

1 R.S.C. 1985 (5th Supp.), c.1.
2 Convention Between Canada and the United States of America With Respect to Taxes on Income and on Capital, September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007.
3 *Id.* Article XXI(2).
4 *Id.* Article XXI(3)(b).
5 *Id.* Article XXI(3)(a). Under Article XXI(1), income derived by a religious, scientific, literary, educational, or charitable organization resident in the U.S. is generally exempt from Canadian taxation to the extent that the income is tax exempt in the U.S.
6 *Id.* Article XXI(4).
7 Note 1, *supra*, at s. 215(6), 227(8), 227(8.3), 227(9), 226(9.2). A Canadian resident may recover from a nonresident the amount of withholding tax that the Canadian resident was liable to pay on the nonresident’s behalf (see subsection 215(6)). Under subsection 227(8.1) of the Act, the nonresident is jointly and severally liable for any interest owing on the amount of withholding tax that the Canadian resident failed to deduct or withhold.
8 See www.cra-arc.gc.ca/E/pub/tg/t4016/t4016-09b.pdf.
9 For instance, on January 19, 2010, the CRA released an updated version of publication T4016, which is current as of March 31, 2009. Prior to January 19, 2010, the list was current as of March 31, 2008. Since CRA publication T4016 is not updated on a real-time basis, certain Trusts that have been approved as Exempt Trusts after March 31, 2009, are not listed, the expiration dates of Letters of Exemption will be incorrect where Exempt Trusts have renewed their Letters of Exemption after March 31, 2009, and a Trust may be listed as an Exempt Trust despite its Letter of Exemption having been withdrawn after March 31, 2009. While Canadian-resident payors should undertake additional due diligence to confirm that a Trust’s Letter of Exemption has not been withdrawn by the CRA prior to its expiration date, it is our understanding that Letters of Exemption are not frequently withdrawn by the CRA.

