

TAX LAW BULLETIN

September 21, 2007

NEW PROTOCOL TO CANADA-U.S. TAX TREATY – ELIMINATION OF WITHHOLDING TAX ON INTEREST AND OTHER CHANGES

Part I of our Tax Series on the Protocol

Canada and the United States signed the widely anticipated 5th protocol (the “Protocol”) to the Canada-U.S. Tax Treaty (the “Treaty”) today. Once it has been ratified by both countries, the Protocol will ultimately eliminate withholding tax on conventional interest payments made by Canadian taxpayers to U.S. residents. Another significant change introduced by the Protocol is the general extension of treaty benefits to limited liability companies (“LLCs”).

The Protocol will enter into force once it has been ratified by both the Canadian and United States governments. The Government of Canada intends to proceed with a Bill at the earliest opportunity. The earliest date on which the Protocol could enter into force is January 1, 2008. This would require both countries to ratify the Protocol in 2007.

The Canadian government has announced that upon ratification of the Protocol, the *Income Tax Act* (Canada) will also be amended in order to eliminate the withholding tax on interest paid to all arm’s length non-residents, regardless of their country of residence.

ELIMINATING WITHHOLDING TAX ON INTEREST

The current Treaty provides that U.S. lenders who are entitled to the benefits of the Treaty are generally required to pay a withholding tax of 10% on interest payments. This amount is withheld by the Canadian borrower and remitted to the Canada Revenue Agency (the “CRA”) on the lender’s behalf. Under the new regime introduced by the Protocol, withholding tax on interest payments between arm’s length persons will be eliminated as of the second month after the Protocol enters into force. Withholding taxes on interest payments between non-arm’s length persons will be phased out over a three-year period.

| Time Following Entry into Force of Protocol | Maximum Withholding Tax Rate on Non-Arm’s Length Interest | Maximum Withholding Tax Rate on Arm’s Length Interest |
|---|---|---|
| Prior to Second Month | 10% | 10% |
| First Year | 7% | 0% |
| Second Year | 4% | 0% |
| Third and Subsequent Years | 0% | 0% |

LLCS

Under current rules, the CRA takes the view that U.S. LLCs are not entitled to the benefits of the Treaty because they are flow-through entities and are not taxable in their own right in the U.S. In highly simplified terms, the Protocol provides that an LLC will generally be entitled to take advantage of the reduced withholding tax rates set out in the Treaty in respect of certain types of payments (e.g. interest, dividends), provided the manner in which the members of the LLC are subject to tax in respect of such payments is the same as if they had received such payments directly. Other treaty benefits will also be granted to LLCs under certain circumstances.

OTHER CHANGES

In unveiling the new Protocol, the Minister of Finance announced that the Protocol contains the following additional elements:

- the elimination of the double taxation of gains realized by emigrants;
- mutual tax recognition of pension contributions;
- clarification of how stock options are to be taxed;
- the ability for taxpayers to solve double taxation issues through arbitration; and
- the implementation of other technical improvements and updates

The Department of Finance released a Backgrounder with further details on the above measures which can be accessed through the following link: http://www.fn.gc.ca/news07/data/07-070_1e.html

MORE TO COME...

This is the first tax bulletin in a series of tax bulletins addressing the new Protocol. Upcoming bulletins will provide a more detailed analysis of the Protocol and how it might affect your tax planning decisions.

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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TAX LAW GROUP

For further information, please contact your McMillan Binch Mendelsohn lawyer, or one of the following members of our Tax Group:

TORONTO

| | | |
|----------------------|--------------|-----------------------------|
| Sheila M. Crummey | 416.865.7017 | sheila.crummey@mcmbm.com |
| Michael Friedman | 416.865.7914 | michael.friedman@mcmbm.com |
| Mary-Ann Haney | 416.865.7293 | mary.ann.haney@mcmbm.com |
| Melissa McBean | 416.865.7073 | melissa.mcbean@mcmbm.com |
| Todd Miller | 416.865.7058 | todd.miller@mcmbm.com |
| Ryan Morris | 416.865.7180 | ryan.morris@mcmbm.com |
| Catherine Roberts | 416.865.7202 | catherine.roberts@mcmbm.com |
| Laura Stoddard | 416.865.7277 | laura.stoddard@mcmbm.com |
| Michael D. Templeton | 416.865.7837 | michael.templeton@mcmbm.com |
| Richard B. Thomas | 416.865.7179 | richard.thomas@mcmbm.com |
| David Wentzell | 416.865.7036 | david.wentzell@mcmbm.com |
| Jamie Wilks | 416.865.7804 | jamie.wilks@mcmbm.com |
| Mickey Yaksich | 416.865.7097 | mickey.yaksich@mcmbm.com |

MONTREAL

| | | |
|----------------------|--------------|--------------------------------|
| Louis-Frédéric Côté | 514.987.5016 | louis-frederick.cote@mcmbm.com |
| Andrew Etcovitch | 514.987.5064 | andrew.etcovitch@mcmbm.com |
| John Israel Galambos | 514.987.5058 | john.galambos@mcmbm.com |

McMILLAN BINCH MENDELSON

TORONTO | TEL: 416.865.7000 | FAX: 416.865.7048

MONTRÉAL | TEL: 514.987.5000 | FAX: 514.987.1213

www.mcmbm.com