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Breaking Developments in Tax Law

10/17/07

New Protocol to the United States-Canada Income Tax Treaty

As anticipated, the United States Department of Treasury and the Canada Department of Finance signed the 5th Protocol ("Protocol") to the existing income tax treaty between the United States and Canada (the "Treaty") on September 21, 2007. The Protocol is expected to be ratified by both countries before the end of 2007 and become effective on January 1, 2008. Once ratified, the Protocol will positively affect cross-border transactions between the United States and Canada. Among a number of changes to the Treaty, the following are significant changes that benefit U.S. taxpayers.

Elimination of Interest Withholding Tax

One of the most significant changes under the Protocol will be the elimination of withholding tax on interest payments. Currently, interest payments from Canadian borrowers to U.S. lenders are subject to a 10% tax that is withheld by the borrowers and remitted to the Canada Revenue Agency (the "CRA"). Under the Protocol, withholding tax on interest paid on arm's length debt will be eliminated, while interest paid between non-arm's length parties (i.e., related parties) will be gradually eliminated. During the first calendar year that ends after the Protocol enters into force, the Treaty reduced rate of withholding will be 7% and will be further reduced to 4% during the second calendar year. After that, the withholding tax will be eliminated altogether. The elimination of interest withholding tax between the United States and Canada under the Protocol provides tax savings for United States lenders and fosters greater participation by Canadian borrowers in the U.S. capital market.

New Treatment for U.S. Limited Liability Companies

In addition to the elimination of the withholding tax on interest, the Protocol also provides a more favorable treatment of U.S. limited liability companies ("LLCs") that are fiscally-transparent (e.g., partnerships or disregarded entities) for U.S. federal income tax purposes. CRA's current position is that since a U.S. LLC that is fiscally-transparent is not a U.S. taxpayer, it is not treated as a "resident of the United States" for Treaty purposes. As such, CRA currently denies Treaty benefits to U.S. LLCs that are fiscally-transparent for U.S. income tax purposes. Further, U.S. members are not currently entitled to preferential Treaty benefits otherwise available to a U.S. resident's Canadian source income. Under the Protocol, U.S. residents who generate Canadian source income through a U.S. LLC will be entitled to benefits afforded by the Treaty. The Protocol technically does not treat the U.S. LLC as a U.S. resident for Treaty purposes; rather, it allows a U.S. resident who is a member of a U.S. LLC to claim Treaty

benefits with respect to income, profit, or gain in Canada that is derived through the U.S. LLC. While the Protocol's language on this matter is brief, its intention to provide Treaty relief to U.S. members who hold interests in an U.S. LLC that earns Canadian source income is clear. Once ratified, this increased access to Treaty benefits for U.S. members of U.S. LLCs will be yet another welcomed change to the Treaty that will further improve business relations between Canada and the United States.

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