Fifth Protocol and Cross Border Business Transactions*

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The Fifth Protocol to the Canada-United States Income Tax Convention, 1980 (Treaty) was ratified by the United States on December 15, 2008. However, many of its provisions were not effective until later dates. Here is a summary of the major changes to the Treaty effective as of January 1, 2010:

(a) Changes in the Treatment of "Limited Liability Companies" and Other Hybrid Entities . (Effective January 1, 2010)

Currently certain entities which are disregarded for income tax purposes in the United States, or which are considered "flow through" entities are considered corporations in Canada. This gives rise to many tax problems related to the recognition of foreign tax credits (especially since the hybrid entity is not considered taxable in the U.S.) Under the new rules, income which is treated as being earned by a member or shareholder of such an entity, will be deemed to be earned by the recipient in the country of residence. This will also coordinate with the interest withholding rules noted below. If a U.S. LLC earns interest income in Canada, the new rules will presume that the U.S. residents earned the income, and will thus eliminate withholding taxes on the income in Canada.

Under new rules, U.S. fiscally transparent entities such as LLC's will be recognized as taxable entities, and will be eligible for Treaty benefits. Although the LLC will be required to file a tax return in Canada since it is considered a corporation, it will be eligible to claim Treaty benefits attributed to its members in the U.S. under the new "look-through" treatment in the Fifth Protocol.

(b) Definition of Permanent Establishment

(Effective January 1, 2010)

The definition of "permanent establishment" was subject to much interpretation in the former Treaty. Under the new rules, the application of benefits in many cases is tied to whether a person or company has a permanent establishment in a contracting state. A permanent establishment is now created where an individual spends more than 183 days in the other state in any 12 month period and during that time more than 50% of the gross revenue generated by the business is derived from services rendered in the other state by that individual.

(c) Proportional Taxation (Effective January 1, 2010)

Consistent with changes in the definition of "permanent establishment" mentioned above, the blanket exemption from taxation available to individuals or businesses providing business services in the other state (but not through a permanent establishment) has been repealed. Now, "business profits" are taxable in each state on a basis proportional to the activity carried out through a permanent establishment in each state.

(d) Elimination of Witholding Tax on Interest Payments

(Implemented over Two Years)

The former 10% withholding tax rate applied to payments of interest between unrelated parties has been eliminated. In transitional provisions, interest paid in 2008 attracts withholding tax at 7%, in 2009 at 4% and in 2010 at 0%). Interest not related to a "permanent establishment" in the other state will be taxable only in the country of residence. This facilitates cross border investment transactions.

1.02 . Canadians Employed in the U.S. and Americans Employed in Canada

A resident of Canada who is employed by a Canadian company to provide services in the U.S, or a resident of the United States who is employed by a U.S. company to provide services in Canada falls under the Canada U.S. Income Tax Convention (Treaty) - Article XV - "Dependent Personal Services", which means that employment income is exempt from taxation and withholding in the other country unless it is over $10,000 per year. If it is over $10,000 per year, it is exempt only if:

- The individual was in the other country fewer than 183 days in any 12 month period, and
- The cost is not borne by (deductible by) a resident employer or an employer with a fixed base in the other country.

Under the former rules, the period of time spent in the other country must have been fewer than 183 days in any calendar year. The Fifth Protocol changes that definition to 183 days in any 12 month period. Care must be taken to ensure that no more than 183 days are spent in the other country on a rolling basis, to maintain protection under the Treaty.

1.03 Providing Self Employed Personal Services Across the Border

A Canadian resident providing personal services in the U.S. as a self-employed individual or a U.S. resident providing personal services in Canada formerly fell under the Canada U.S. Income Tax Convention (Treaty) -- Article XIV - "Independent Personal Services", which exempted self employment income from taxation in the U.S. regardless of amount or time spent in the U.S. as long as no permanent establishment was maintained in the other country. Effective January 1, 2008, Treaty Article XIV has been eliminated and replaced by the proportional taxation rules noted above.

1.04 The Fifth Protocol – Practical Application of Business Provisions

Based on the changes in the Fifth Protocol, and their effective dates, the following are likely practical strategic solutions to cross border business situations over the next several years:

For 2009 Returns:

- Canadian corporations engaging individuals to work in the U.S. should consider whether they have a permanent establishment in the U.S. If not, then filings in the U.S. will be similar to those in prior years where Treaty Article XIV was available, but that Treaty Article VII pertaining to business profits would be invoked instead. The former rules for determining a "permanent establishment" would be used.
- Individuals working for Canadian corporations in the U.S. would file in accordance with Treaty Article XV – Employment Income.
- U.S. corporations engaging individuals to work in Canada may also be exempt from Canadian taxation under Article VII if they do not maintain a permanent establishment in Canada.
- Individuals providing services in the other country as self employed contractors may still be able to claim Treaty exemption from taxation under Article VII if they do not maintain a permanent establishment in the other country.

- Care should be taken to pay appropriate withholding taxes to individuals engaged by corporations in the other country in an amount sufficient to eliminate corporate taxable income.

For 2010 Returns:

- The new definition of "permanent establishment" will be used. This will likely result in a majority of cross border contractors being considered to have a permanent establishment in the other country.
- As a result of the above, care should be taken to pay sufficient salary in the other country (subject to the usual withholding rules) to eliminate corporate taxation. Failure to do so will result in taxation on a proportionate basis in the other country.
- For corporations considered to have a permanent establishment in the other country, a full tax return will be required, showing line by line income and expenses, regardless of whether there will be a net profit.
- Canadian corporations with a fiscal year end other than December 31, will need to either change their year end to December 31, or maintain a separate set of books on a calendar year basis, for reporting of personal services company income in the U.S.