Fifth Protocol and Cross Border Business Transactions*

1.01 Introduction:

The Fifth Protocol to the Canada-United States Income Tax Convention, 1980 (Treaty) was first drafted on Setpember 21, 2007, and was ratified by Canada on December 14, 2007 when Bill S-2 received royal assent. The process of ratification in the United States took somewhat more time, but the Fifth Protocol was ratified by the United States on December 15, 2008, when the bill was signed by President Bush.

The Fifth Protocol made sweeping changes to many of the terms of the Treaty, and also corrected many interpretations and other issues which have arisen over time. Since the Fifth Protocol changes many of the terms of the original Treaty, it is important to note the changes and the effective date of some of its provisions:

1.02 Summary of Major Provisions Affecting Cross Border Business

Unless otherwise noted, the Fifth Protocol provisions are effective January 1, 2008.

(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. (A corollary rule to take effect in two years provides that if income is NOT to be recognized by the individual member in the country of origin, it will NOT be taxable in the country of residence.) This will also coordinate with the interest withholding rules noted above. 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.

A Canadian Unlimited Liability Company (ULC) is considered a corporation in Canada, but as a partnership in the U.S. The new "anti hybrid" rules contained in the Fifth Protocol will apply a withholding tax of 25%

on all distributions (whether deductible in Canada or not) to U.S. shareholders of a ULC. There are many complications in this treatment, and taxpayers who have set up structures to double deductions in this manner may have to reconsider their corporate structure. Since the conversion of a ULC to a taxable corporation in the U.S. may be considered to be an outbound transfer of assets, restructuring may need to involve the interposition of a holding company in a third country to prevent unacceptable results.

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) Mutual Recognition of RRSP's and IRA's

(Effective January 1, 2009)

In this major change, cross border workers may be able to deduct contributions to pension plans made abroad in their country of residence. This means that if a Canadian works in the U.S. and contributes to a U.S. retirement plan, that deduction would be allowable on his Canadian return (as well as in the U.S.) to the limit of his RRSP contribution room. Similarly, U.S. citizens working in Canada and making RRSP contributions or pension plan contributions will be able to deduct the contributions on their U.S. returns.

(c) Stock Option Benefit - Apportionment of Taxation

(Effective January 1, 2009)

Currently it is not clear how income tax will apply in situations where an employee becomes entitled to a stock option in one country and then moves to the other country before exercising or disposing of the stock. Under the new rules, taxation will be proportionate to the amount of time spent working (and earning the option) in each country.

(d) 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 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. A permanent establishment may also be created where services are provided in the other state for more than 183 days in any 12 month period with respect to a project for a resident of the other state.

(e) Article XIV Eliminated

(Effective January 1, 2008)

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. This change will affect the taxability of Canadian corporations and individuals providing services in the U.S. and U.S. entities providing services in Canada.

(f) Cross Border Employment Provisions Substantially Unchanged

(Effective January 1, 2008)

Employment income will continue to be taxable only in the country of residence, unless the income was earned from services performed in the other country and if the employee spends more than 183 days in the other country, and earns more than $10,000 while on foreign assignment. The income will also be taxable in the other country if the salary is "borne by" a resident of the other country. (This last provision extends the Treaty benefit to short term employees transferred to the other country by their employer in the country of residence.)

(g) 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.

(h) Departure Tax – Double Taxation Eliminated with Bump Up of Basis

(Effective September 17, 2000)

Under current rules, a person departing from Canada was (and continues to be) required to declare capital gains and losses arising from "deemed dispositions" on departure from Canada, based on the fair market value of capital properties held on the date of departure. Under the new rules, the taxpayer can elect to have realized his gain before becoming a resident of the U.S. and therefore the U.S. would only tax capital gains on changes in value from the date of entry onward. (Certain U.S. citizens returning to the U.S., however, may be taxable on capital gains based on their world income.)

1.03 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 states:
"Subject to the provisions of Articles XVIII (Pensions and Annuities) and XIX (Government Service), salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State."

This has been defined to mean 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.

Therefore, to be exempt under the Treaty, a Canadian resident individual must be employed in the U.S. by a Canadian corporation without a fixed base in the U.S. for a period of fewer than 183 days. Employment in the U.S. by U.S. employers, and Canadian employers with a permanent establishment or fixed base in the U.S. is fully taxable in the U.S. Similarly, a U.S. resident must be employed in Canada by a U.S. resident corporation without a fixed base or permanent establishment in Canada for a period of fewer than 183 days to be exempt from tax in Canada.

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.

Employers with a fixed base in the other country who hire or transfers persons to work in the other country should ensure that withholding taxes are deducted and remitted to the other country, and that withholdings to the home country are eliminated, except for those required to fund social security (under the Totalization Agreement). Failure to do so can create a cash flow problem for the employee, since they will be primarily taxable in the other country and will have to pay taxes in the other country before the home country withholdings are recovered through the operation of the foreign tax credit.

1.04 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 instead replaced by the following in the Fifth Protocol, effective on the following implementation dates:

(a) Permanent Establishment Defined *(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. A permanent establishment may also be created where services are provided in the other state for more than 183 days in any 12 month period with respect to a project for a resident of the other state.

(b) 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.

1.05 Providing Personal Services in the Other State Through a Corporation

A private corporation may be used to provide personal services in the other country. In such a case the individual providing the services would fall under Treaty Article XV (Dependent Personal Services) for the time spent providing services in the U.S. The corporation would be proportionally taxable in the other state if it has a permanent establishment there as defined in the Fifth Protocol to the Treaty.

If the individual has no other dealings in the other country, the individual employed by his own corporation may fall under Treaty Article XV (Dependent Personal Services) if the time and income threshold amounts are met.

Any US person (including someone who becomes a US person during the year) must include in current taxable personal income on his 1040, his distributive share of Subpart F income earned by a foreign controlled corporation during the year on form 5471 whether distributed or not (subject to some deductions for qualifying deficits) pursuant to IRC Sec 951. Subpart F income includes income of the foreign corporation which relates to passive activities like rents, interest and dividends (unless part of active business), services rendered outside the foreign country, foreign personal holding company income, sales commissions earned for sales outside of the foreign country.

This law includes personal service income of US persons, which has been channeled through a foreign country in their personal corporation. Therefore, a Canadian who goes to the US to work providing personal services in the US through a Canadian corporation he/she controls, and becomes a US person by virtue of residence, would be liable to include all net service income in his/her US return which is earned by the Canadian corporation, whether distributed or not. To further complicate matters under US rules (IRC267), Canadian style accruals of management bonuses are not permitted to cash basis related parties, and all "bonus" amounts must be paid within the tax year increasing the complexity of tax planning for corporations operating in the U.S.

Canadians who operate a small business corporation that would otherwise be eligible for the "Small Business Deduction" under Para. 125 of the Income Tax Act (Canada) should be cautioned that in order to be eligible for the low corporate rate of tax on Canadian Controlled Private Corporations, the corporation must be engaged in an active business carried on in Canada. Income from personal services rendered by the majority shareholder in the U.S. and paid to the corporation will not be eligible for the lower Canadian corporate rate of tax.

(a) Residents of Both Canada and the U.S.

Many individuals may find themselves residents of both Canada and the U.S. as a result of the application of the taxation rules in each country. Under dual residence circumstances, double taxation can be eliminated if filings are made on a timely and accurate basis.

1.06 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 2008 and 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.

1.07 Alternative Minimum Tax

The operation of the Alternative Minimum Tax (AMT) rules may sometimes limit the benefit of items otherwise deductible. Under AMT all income items and deductions are re-calculated using AMT rules, and a separate tax rate is applied, subject to the AMT deduction. The tax actually payable in any year is the higher of the tax calculated under the regular rules, and that calculated under the AMT rules. Although the rules for AMT calculation differ in the U.S. and Canada, they operate in a similar manner, and can give rise to a tax liability where no tax would otherwise be payable.

1.08 Totalization Agreement - Social Security

An international agreement respecting social security between Canada and the U.S. sets out the rules for social security taxation for residents of one country working in the other. This agreement, also known as the Totalization Agreement, provides that a person on temporary assignment in the other country may opt out of social security in the other country for a period of up to five years.

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