New Protocol to US-Canada Tax Treaty Would Eliminate Withholding Tax on Interest Payments

On September 21, 2007, United States Treasury Secretary Henry Paulson and Canadian Finance Minister Jim Flaherty signed the much anticipated 5th protocol to the existing United States-Canada income tax treaty (the "Treaty"). If ratified, the protocol will make a number of significant changes to the Treaty, including:

Elimination of Withholding Tax on Payments of Interest
The current Treaty provides that lenders that are resident in one Treaty country and are receiving interest payments from borrowers resident in the other Treaty country are generally subject to a withholding tax of 10 percent on such interest payments. The protocol provides that withholding tax on the interest paid on arm's length debt will be eliminated as of the second month following the protocol's entry into force. Withholding tax on interest payments between related persons will also be eliminated; however, such withholding tax will be phased out over a two-year period.

Treatment of Fiscally Transparent Entities
Under the current Treaty, the treatment of income derived through certain fiscally transparent entities (e.g., a US limited liability company) is not completely clear. Under the protocol, investments made through a fiscally transparent entity will generally be entitled to reduced withholding rates in respect of certain types of payments, including dividends and interest, provided that certain conditions relating to the members of the entity are satisfied. Among such conditions is the requirement that the members be taxed in respect of such payments in the same manner as if they had received the payments directly. Certain other Treaty benefits may also be available to residents of Canada or the United States making investments through fiscally transparent entities.

Other Highlights
Among other provisions and technical clarifications in the protocol are new mandatory arbitration procedures for disputes with regard to certain Treaty provisions, new standards for establishing a "permanent establishment" in connection with the performance of services by a Treaty resident, and clarifications as to the tax treatment of pension contributions and the exercise of employee stock options.

The protocol must be approved by both the US Senate and the Canadian Parliament before it can enter into force. Timing as to ratification is unclear. However, if ratified by both countries before the end of 2007, the protocol will enter into force on January 1, 2008.

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