

The Canada-US Regulatory Regime: Review, Reform, Recovery

*Recent Developments in
Canada-U.S. Cross-Border Tax*

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Recent Developments

- Canada-U.S. Tax Treaty Update:
 - Canada's approval of the Technical Explanation a sign of the close relationship
 - Various changes introduced to simplify cross-border business activity
 - Certain provisions of the amended Treaty have only recently come into force
 - Market practice is evolving as Treaty issues are raised and the Canada Revenue Agency (CRA) begins to offer its views on interpretation of the amended Treaty
- Changes to Domestic Canadian Tax Law:
 - Changes announced in the March 2010 Canadian federal Budget eliminate tax, withholding and compliance burdens for non-Canadian investors disposing of Canadian equity, except where the equity constitutes an actual or deemed real property interest
 - Changes announced to complex and contentious proposed anti-avoidance rules

Agenda

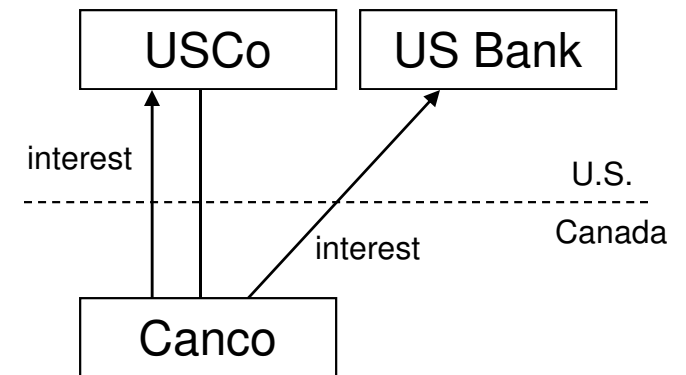
- Canada-U.S. Tax Treaty Update
 - Mandatory Arbitration
 - Withholding Tax on Interest
 - LLCs and Fiscally Transparent Entities
 - Anti-Hybrid Rules
 - Reciprocal Limitation on Benefits Rules
- Recent Canadian Domestic Changes
 - Taxable Canadian Property
 - “Non-Resident Trust” and “Foreign Investment Entity” Rules

Canada-U.S. Tax Treaty Update: Mandatory Arbitration

- Introduced as a dispute resolution mechanism for the Mutual Agreement Procedure
- Conditions must be met
- Based on exchange of Notes, applies only to Arts. IV (Residence), V (Permanent Establishment), VII (Business Profits), IX (Related Persons), and parts of XII (Royalties)

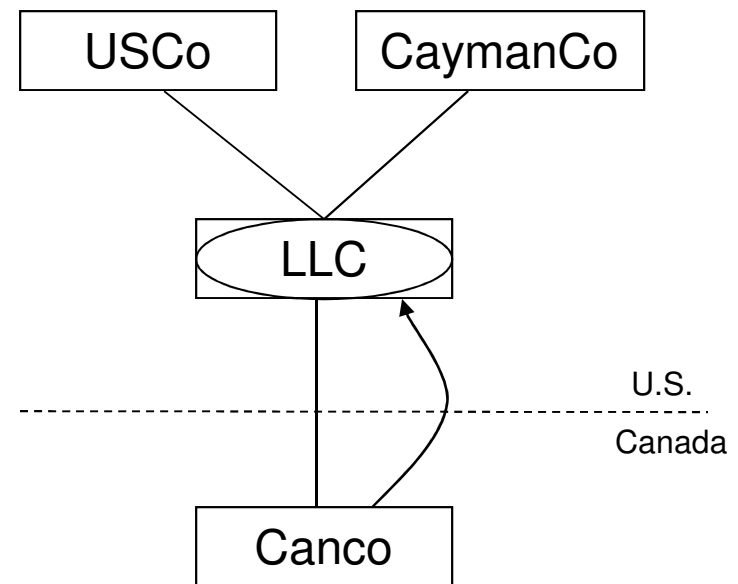
Canada-U.S. Tax Treaty Update: Withholding Tax on Interest

- Zero withholding tax on arm's length interest as of January 1, 2008 under domestic Canadian law
- Under Canada-U.S. Tax Treaty, effective January 1, 2010, zero withholding tax on most related party interest paid to qualifying U.S. residents
- Withholding tax still applies to participating interest



Canada-U.S. Tax Treaty Update: LLCs and Fiscally Transparent Entities

- Issue: most LLCs not considered residents of the U.S. by Canada for Treaty purposes
- Advertised solution: “extending treaty benefits to LLCs”
- Article IV(6): a look-through rule, to the extent of “good” U.S. persons

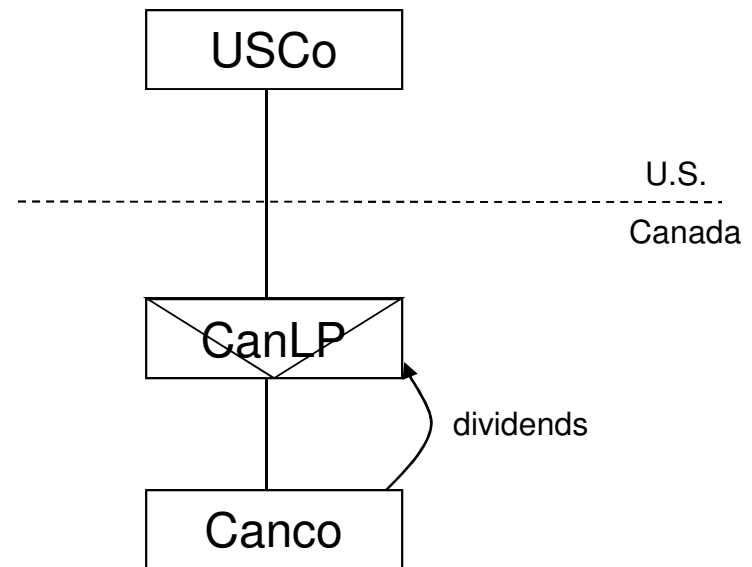


Canada-U.S. Tax Treaty Update: LLCs and Fiscally Transparent Entities

- If relieving rules does not apply, LLC is considered opaque and cannot qualify for Treaty benefits
- Deemed payments – e.g. dividends arising in Canada as a result of conferral of a shareholder benefit or a stated capital increase may be a problem
- Deemed payments for Canadian tax purposes give rise to Canadian withholding tax; however, as there is no actual payment they are often considered “nothings” for U.S. tax purposes
- Because of this disregarded treatment in the U.S., Canadian authorities have suggested that Article IV(6) may not apply – is that the right answer?
- Uncertainty remains

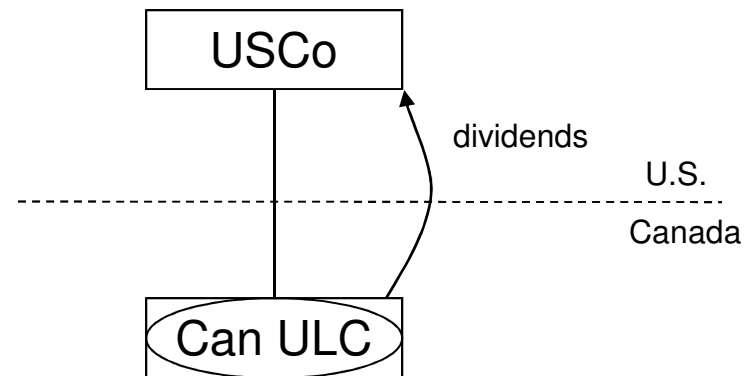
Canada-U.S. Tax Treaty Update: Anti-Hybrid Rules

- Anti-hybrid rule in Treaty came into effect January 1, 2010
- Art. IV(7)(a) applies to a “source state” entity that is transparent for domestic purposes, but not in the “residence state”



Canada-U.S. Tax Treaty Update: Anti-Hybrid Rules

- Art. IV(7)(b) applies to a “source state” entity that is “opaque” for domestic purposes, but transparent in the “residence state”
- Intended to catch “double dip” financing structures, but very broad in its application to “normal” structures
- Applies to both deductible and non-deductible payments



Canada-U.S. Tax Treaty Update: Anti-Hybrid Rules

- Payment of a dividend or interest from fiscally transparent ULC to its U.S. shareholder would be subject to withholding tax at 25% statutory rate
- Structural solutions may be available in respect of dividend and interest payments
 - two-step process for dividends
 - multiple shareholder ULCs for deductible payments, subject to possible attack if there is a “double dip”

Canada-U.S. Tax Treaty Update: Reciprocal Limitation on Benefit Rules

- Benefits only available (i) to qualifying persons; (ii) under the “active conduct of a connected trade or business” test; (iii) under a “derivative benefits” rule for dividends, interest and royalties; or (iv) upon application to the Competent Authority
- Canada adopted existing provisions, with minor changes
- Difficulties of interpretation arise in the Canadian context where words were drafted from a U.S. perspective

2010 Canadian Federal Budget: Taxable Canadian Property

- In the 2010 Canadian Federal Budget, the Government of Canada announced dramatic and unexpected favourable changes to tax laws applicable to foreign investors in Canadian businesses
- The scope of taxation of non-residents has been narrowed, bringing it closer in line with many other developed countries and Canada's network of tax treaties

2010 Canadian Federal Budget: Taxable Canadian Property

- Canada taxes foreign investors on gains from sales of “taxable Canadian property” (TCP)
- Under current law, TCP definition is very broad and includes all Canadian private company shares as well as significant interests in Canadian public company shares
- Most of Canada’s bilateral tax treaties provide an exemption from Canadian taxation of gain on sale, except where the property being sold is a real property interest

2010 Canadian Federal Budget: Taxable Canadian Property

- “Section 116” compliance required on a disposition of TCP
- Non-residents disposing of TCP must obtain a section 116 certificate issued by CRA, even if no gain is realized on disposition or gain is treaty-exempt
- If no certificate is provided at closing, purchaser will generally withhold 25% of purchase price to be placed in escrow pending receipt of certificate (or remittance to CRA)
- CRA review of section 116 application typically takes months, and requires disclosure of significant information regarding identity of seller and any entitlement to treaty protection

2010 Canadian Federal Budget: Taxable Canadian Property

- New rules effective in 2009 were intended to provide relief, but are considered flawed and have not been adopted by the market
- Non-residents disposing of TCP must also file a Canadian tax return in certain circumstances

2010 Canadian Federal Budget: Taxable Canadian Property

- Under proposed legislation, TCP will only consist of:
 - Canadian real property (including resource property)
 - property used in a Canadian business
 - designated insurance property of insurers and
 - shares (or interests in trusts and partnerships) that are real property interests
- Options to acquire such types of property will also be TCP

2010 Canadian Federal Budget: Taxable Canadian Property

- Deeming rules exist in respect of certain rollover transactions, but will be amended to apply for 60 months (even if no real property interest)
- Property that is TCP only because of a deeming rule in the ITA is not subject to section 116 compliance
- Deemed TCP rules are therefore more relevant to sellers rather than buyers

2010 Canadian Federal Budget: Taxable Canadian Property

- Outstanding Issues:
 - Currently there is no due diligence defence
 - Will certification forms be released by the CRA to provide purchasers with certainty?
 - Ongoing need to use third-country blockers?
 - New TCP definition will mean third country blockers can be eliminated when structuring many new investments, especially where focus is on exit
 - Blockers may still be relevant where shareholder expects to receive periodic interest payments or dividends

2010 Canadian Federal Budget: NRT and FIE Rules

- The Non-Resident Trust (NRT) and Foreign Investment Entity (FIE) rules are anti-avoidance rules that have been proposed in various forms for many years
- These rules are very complex, with many technical deficiencies
- The Advisory Panel on Canada's System of International Taxation recommended a complete review of these rules in December, 2008
- FIE Proposals have been withdrawn
- Proposals in the Budget will amend the NRT rules to provide greater certainty and clearer exemptions for commercial trusts

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