Collins Barrow
Chartered Accountants

Tax Alert

FALL 2007

Amendments to the Canada-US Tax Treaty

The fifth Protocol to the Canada-US Income Tax Convention was signed on September 21, 2007, and is anticipated to come into force in early 2008. With certain exceptions, the amendments will take effect for taxable years commencing after the calendar year in which the Protocol comes into force.

Elimination of withholding taxes on interest

Withholding tax on interest paid between Canadian and US residents will be eliminated. For arms-length interest, the change will be effective for amounts paid or credited on the first day of the second month after the month in which the Protocol comes into force.

There will be a phased-in elimination for interest between related persons, from the current rate of 10%, to 7% for amounts paid after the date on which the withholding changes become effective and before the end of that calendar year (presumably 2008), 4% in the following year, and 0% thereafter.

Draft legislation has been released to amend the Canadian Income Tax Act, eliminating withholding tax on interest paid to arms-length non-residents, regardless of their country of residence. These provisions will be effective concurrent with the treaty withholding tax changes.

The Protocol also eliminates withholding taxes on guarantee fees, which are presently treated as interest for withholding tax purposes.

Withholding taxes on dividends

The Protocol does not propose to reduce the treaty withholding rates on dividends, which will continue to be 15% generally, and 5% for corporate shareholders who hold at least 10% of the voting shares of the dividend payor. However, the Protocol introduces rules to look through certain "fiscally transparent" entities, including partnerships, to determine if a particular partner/owner meets the 10% ownership threshold for the 5% withholding rate. This will allow corporate partners, for example, to obtain the lower withholding rate if their proportion of the voting shares owned by the partnership is at least 10%.

The Protocol will extend the 15% treaty withholding tax on distributions by US-based Real Estate Investment Trusts (REITs), presently restricted to individuals owning less than 10% of the REIT, to other persons, including corporations, that are below certain ownership thresholds.

Withholding taxes on royalties and real estate rentals

Withholding taxes on royalties will continue to be limited to 10% under the treaty, except those royalties that are exempt from withholding entirely. Withholding tax will continue to apply to real property rentals (see accompanying article in this issue of Tax Alert).

Expansion of definition of permanent establishment for service providers

Business profits earned on the other side of the border generally are taxable under the treaty only where they are connected with a permanent establishment of the taxpayer in the other country. The Protocol expands the definition of permanent establishment to cast a wider net over certain cross-border service providers. A taxpayer resident in one country will be considered to have a permanent establishment in situations where services are provided in the other country in respect of the same, or a connected, project for 183 days or more in any 12-month period, and are provided either to a resident of that other country or in respect of a permanent establishment of another person not resident in that other country. It will also catch enterprises that provide services through an individual who is present in the other country for 183 days or more in any 12-month period, if more than 50% of the enterprise's gross active business income during that period is derived from those services. These rules will apply to the third taxable year commencing after the Protocol comes into force, but in any case exclude service days and revenues arising prior to January 1, 2010.

Stock option sourcing rules

The Protocol removes uncertainty over sourcing of stock option benefits. Where an option is granted in one country and the employee subsequently works for the same or a related employer in the other country, the benefit will be allocated between the countries based on the proportion of time between the grant date and the exercise date that is spent at the principal place of employment in each country.

Deduction of pension contributions

The Protocol introduces rules to allow employees crossing the border, but continuing to participate in a pension plan in the original country, to deduct plan contributions for both Canadian and US tax

Continued on Page 4

RRSP Excess Contributions

Are you one of a number of Canadians who has inadvertently overcontributed to your RRSP? If so, you should be aware that the Canada Revenue Agency (CRA) is carrying out a project through which they have contacted taxpayers who 'may' have overcontributed to their RRSPs. Excess RRSP contributions are subject to a penalty tax of 1% per month of the excess contribution.

What are RRSP excess contributions?

Generally, you have RRSP excess contributions when your unused RRSP contributions made to your, or your spouse's or common law partner's, RRSP plan exceed your RRSP deduction room plus $2,000 (the allowable overcontribution). Your unused RRSP contributions and RRSP deduction room can be found on your RRSP Deduction Limit Statement which forms part of your Notice of Assessment.

How does the 1% penalty tax work?

The penalty tax of 1% per month may apply to certain excess contributions you made in 1991 and later years, that are left in the plan. However, if your unused contributions resulted from qualifying mandatory group RRSP contributions or from contributions made before February 27, 1995, you may not have to pay this 1% tax on all your unused contributions.

The 1% penalty tax on RRSP excess contributions applies for each month that the contributions remain in an RRSP or until your excess amount is reduced by new RRSP deduction room. Penalty tax arising at any time in the year is due and payable 90 days after the end of the year. CRA provides Form T1-OVP Individual Tax Return for RRSP Excess Contributions to calculate the tax owing. This form must be filed within 90 days of the year-end. Failure to file may result in penalties.

It is up to the taxpayer to self-assess the penalty tax on excess contributions. However, if CRA becomes aware of the situation, they will send a request to file Form T1-OVP.

What do I do with my RRSP excess contributions?

Where you inadvertently make excess RRSP contributions, you may want to reduce continuing penalties by withdrawing the amount of the excess beyond the permitted $2,000. RRSP withdrawals must be reported in your personal tax return in the year of withdrawal. However, you may be able to claim a deduction equal to the amount withdrawn if you reasonably expected to be able to deduct the contributions, and you received the unused RRSP contributions:

a) in the year you contributed them, or in the following year; or
b) in the year you received a Notice of Assessment or Reassessment, or in the following year.

The intent is to allow you to withdraw an overcontribution, without any tax consequences, as soon as you realize that penalty tax may arise. You must withdraw from the same type of plan as that to which the unused contributions were made, either your own RRSP or an RRSP for your spouse or common-law partner.

If you overcontributed in 2006 you have until the end of 2008 to remove the excess contributions and have no tax on the withdrawal. The penalty tax of 1% per month still applies during your period of overcontribution.

You can withdraw from an RRSP without withholding tax by completing and filing tax Form T3012A: Tax Deduction Waiver on the Refund of Your Undeducted RRSP Contribution. This form asks the CRA for permission to remove RRSP overcontributions without having tax withheld. Once the T3012A is filed, the CRA is aware of the overcontribution and will ask you to fill out the T1-OVP form to calculate the penalty tax.

If you withdraw RRSPs without Form T3012A, the issuer of the plan must withhold tax of 10%, 20% or 30%, depending on the dollar amount withdrawn. The tax withheld can be claimed on your personal tax return in the year of withdrawal. Since no T3012A form is filed, the CRA may not become aware of the RRSP overcontribution, however, the onus is still on you to file Form T1-OVP and pay the penalty tax.

The rules surrounding excess RRSP contributions can be complicated and the related forms difficult to complete. The CRA is contacting taxpayers who 'may' have excess RRSP contributions. However, receipt of a letter from the CRA does not necessarily mean you are offside of the RRSP contribution rules. Contact your Collins Barrow advisor for assistance if you are concerned about RRSP excess contributions.

Kathy McIntosh is a tax partner in Collins Barrow's Winchester member firm.

Canadians Owning US Real Estate

A growing number of Canadians own rental property or personal real estate in the United States. Such owners should ensure they are aware of the applicable US income tax requirements. Taking steps to understand and comply with these US tax rules could result in significant US income tax savings and avoidance of penalties and interest.

Canadians collecting rent from US real estate

When a Canadian individual receives passive rental income from real estate in the United States, 30% of the gross rental payment must be withheld and remitted to the Internal Revenue Service (IRS) on behalf of the Canadian property owner. The Canadian owner must file forms with the IRS by March 15th of the following calendar year, reporting the gross income and the taxes withheld. Failure to file such forms and remit the withholding taxes will result in penalties.

Individuals may, however, choose to elect to have their passive rental income taxed as if it was "effectively connected with the U.S. trade and business" by filing a US income tax return and paying US tax on the net rental income. An election to do so must be filed with the return for the year in which the property is first rented. Once such an election is made, there is no obligation to withhold the 30% tax. The election will remain in effect until the IRS consents to a revocation.

Generally, Canadian residents have until June 15th of the following year to file US income tax returns without penalties. Late filing of returns is usually allowed, though often subject to penalties. However, if the US tax return is not filed by October 15th of the second year following the year the rent was collected, the IRS may deny the deduction of expenses against the rental income, causing the gross rent to be subject to the 30% flat tax. For example, if a Canadian collected US rental income in 2005, the US tax return must be filed by October 15, 2007. If it is not, the gross rent could be subject to a 30% tax. If returns for years prior to 2005 have not been filed, the individual must decide if it is best to file voluntarily now and hope the IRS will allow tax to be paid on the net rental income, or live with the risk of the IRS assessing the 30% tax at a later date. The IRS is likely to become aware of the issue when the property is sold. It is often best to file late income tax returns voluntarily and pay the tax due. Professional advice should be sought in such a case, however.

Canadians selling US real estate

Gains from dispositions of US real estate are subject to tax in the US regardless of whether the property has been used personally or rented. If a Canadian disposes of US real estate, the purchaser generally is required to withhold and remit 10% of the purchase price, with certain limited exceptions. This withholding essentially represents a prepayment of the capital gains tax that the Canadian may owe in the US. The Canadian must file a US tax return reporting the capital gain, and the withholding tax is credited against the actual US tax liability, if any. If the withholding tax exceeds what is due, the IRS will issue a refund to the Canadian once a US tax return is filed. This process can, of course, take a significant amount of time and in the meantime the 10% tax remains with the IRS. Depreciable property may also give rise to recaptured depreciation, and the cost base for capital gains purposes may be reduced by prior depreciation amounts, even if these amounts were not claimed as deductions in prior years.

The withholding tax can be reduced if a withholding certificate is issued by the IRS. A withholding certificate may be issued if the amount that would be withheld is more than the maximum tax liability on the sale. Normally, the IRS requires 90 days to act on an application for reduced withholding. The Canadian seller, the purchaser, or the agent of either may request this withholding certificate, provided all parties to the transaction have an Individual Taxpayer Identification Number. Canadians are advised to apply for an Individual Taxpayer Identification Number well in advance of any potential real estate sale to ensure that the IRS can consider any such application for reduced withholding prior to the sale closing.

In addition to the income tax requirements mentioned above, there may be other issues to consider, such as US estate taxes or sales taxes. Of course, Canadian residents must also report all rental income and capital gains on their Canadian tax returns regardless of any US returns filed.

Contact your Collins Barrow advisor for professional assistance regarding ownership of US real estate.

Karen Sands is a tax partner in Collins Barrow's Kingston member firm.

Continued from Page 1

purposes. The changes will affect those who relocate on a short-term basis (5 years or less),commuters who work and make pension contributions cross-border, and US citizens residing in Canada.

Relief from double-taxation of pre-emigration gains

The Protocol provides that, where an individual moves between the two countries and is deemed to dispose of property in one country at the time of emigration, the individual may elect in the other country to be deemed to have disposed of, and to have re-acquired, the property at its fair market value immediately prior to the date of emigration. Ordinarily, the election will not result in any tax in the second country, and will provide an increased cost base for determining gains on future dispositions.

US Limited Liability Corporations

LLCs are usually treated as flow-through entities for US tax purposes, but are generally considered to be foreign corporations for Canadian tax purposes. The Canada Revenue Agency takes the view that LLCs are denied many of the benefits under the present treaty, causing a number of problems:

- If the "mind and management" of an LLC reside in Canada, the LLC could be found to be a Canadian resident under common law and subject to Canadian tax on its worldwide income. For other corporations, the treaty provides relief by deeming a corporation to be resident where it is incorporated.
- Where US LLCs carry on business in Canada, Canadian income tax could be assessed on business profits even where the LLC has no permanent establishment in Canada.
- Dividends received by an LLC from a Canadian corporation would not qualify for reduced rates of withholding tax under the treaty that ordinarily apply to US residents.

The Protocol has addressed the issue of withholding tax by providing rules on sourcing of income that are designed to have the members of the LLC, rather than the LLC itself, report the income for Canadian tax purposes. Further guidance from the federal government will be required as to the mechanics of this relief in specific fact situations. Unfortunately, the Protocol does not include general recognitions that LLCs are US residents, and therefore it will continue to be important to avoid inadvertently establishing common-law residence of an LLC in Canada (for example, by having a majority of LLC directors resident in Canada).

Hybrid entities

Many cross-border structures are devised to take advantage of the fact that certain entities can be classified as flow-through in one country, and non-flow-through in the other. For example, a partnership may elect to be treated as a corporation for US tax purposes, but remain a flow-through entity to its partners for Canadian tax purposes. The Canadian government considers some of the tax advantages created under these structures to be inappropriate, and the Protocol now adds provisions that seek to limit those benefits, effective the first day of the third calendar year ending after the Protocol comes into force. The effect of the changes will need to be evaluated for all cross-border structures involving such entities, not just those the government was targeting.

One unexpected change adversely affects Unlimited Liability Companies. ULCs are commonly used by US residents to invest in Canada since they can be treated as partnerships, or as "disregarded entities," for US tax purposes. The Protocol will deny the reduced rate of treaty withholding on dividends paid by such entities to US residents, boosting the withholding rate to 25% from the 5-15% that applies presently. The rate on interest paid to non-arms-length US residents by ULCs will also increase to 25%, versus the 0% (after phase-in) that will apply to interest payments by other corporations. Arms-length interest paid by ULCs will not be subject to withholding, due to the Canadian domestic amendments described above.

The Protocol includes various other changes that will affect cross-border planning. Please contact your Collins Barrow tax advisor for more information.

Dean Woodward and Brian McColl are tax partners in Collins Barrow's Calgary office.

Collins Barrow Office Locations:

Banff	Hearst	Sarnia
Bobcaygeon	Kapuskasing	Stratford
Brockville	Kingston	Strathroy
Calgary	Leamington	Sturgeon Falls
Cambridge	Lindsay	Sudbury
Canmore	London	Toronto
Carleton Place	Manotick	Vancouver
Chatham	Montreal	Vaughan
Chelmsford	North Bay	Waterloo
Edmonton	Orangeville	Winchester
Elora	Ottawa	Windsor
Exeter	Peterborough	Winnipeg
Halifax	Red Deer	

Contact Information:

Internet: www.collinsbarrow.com

Email: info@collinsbarrow.com

Careers: careers@collinsbarrow.com

Collins Barrow regularly publishes Tax Alert for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada. While Tax Alert suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.