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On the positive side, Canadians can now more readily access international capital markets. Canada has repealed its withholding tax on interest paid to arm's length foreign lenders. The relief is broad covering debt of all maturities and related financing costs.

All foreign arm's-length lenders benefit from the exemption regardless of whether their home jurisdictions provide reciprocity to Canadian lenders. However, the exemption does not apply to participating debt interest linked to factors such as revenues, profits, commodity prices or dividends.

On July 14, 2008, Canada introduced draft legislation aimed at accommodating income funds and certain partnerships caught by the specified investment flow-through (SIFT) legislation. SIFT funds and partnerships were attractive structures to hold business assets, resource properties and real estate because income could be distributed without an intervening level of double taxation. The new rules will make such entities taxable for years ending after December, 2010. The draft legislation allows SIFT funds and partnerships to permit tax-deferred conversions into corporations by way of either a unit exchange or a wind up transaction.

There are also some negative developments that will affect investor and market attitudes. Among these are Canada's disappointing proposals to amend its reporting rules, which have long frustrated foreign arm's-length sellers of many Canadian-based investments. The absence of any action to redress necessary changes to rules that leave many Canadian businesses exposed to huge currency gains on repayment of foreign denominated debt—with no recognition for offsetting real economic losses on underlying investments—is disappointing.

New legislation also denies—after 2011—interest deductibility to Canadian corporations in respect of so-called double-dip financing structures. Corporations use such structures to finance foreign acquisitions with the tax benefit of allowing, in effect, the same interest deduction to reduce both Canadian and foreign taxes. The rules are extremely complex and will apply well beyond the scope of their expressed purpose.

The Fifth Protocol to the Canada-U. S. Tax Treaty—which Canada ratified in December, 2007—contains both (expected) relieving provisions and (unexpected) changes that eliminate treaty benefits. The Treaty extends benefits to U. S. limited liability companies (LLCs), exempts withholding tax on guarantee fees and, over a three-year phase-in, related party interest payments. “Look-through” provisions will permit corporate members of fiscally transparent entities the reduced 5% substantial interest dividend withholding rate.

However, the Protocol introduces complex “anti-hybrid” rules that will deny treaty benefits to entities, such as partnerships and certain companies that are considered fiscally transparent in one country but not in the other.

Also on the treaty front, because of several legal defeats in the courts, Canada added its first comprehensive limitation on benefits provision intended to curtail tax treaty shopping. We can expect to see similar provisions when Canada negotiates its other treaties.

The Fifth Protocol also introduces the concept of binding “baseball-style” arbitration to settle disputes between the competent authorities of the two countries.

On July 10, 2008, the U. S . Treasury released its Technical Explanation relating to the Fifth Protocol. Canada has approved the explanation. Unfortunately, it fails to answer several questions. The United States will likely ratify the Fifth Protocol after the November elections.

Taxpayers have fared well in the Tax Court of Canada in international corporate and M&A activities. In Prevost Car, the tax court rejected the government’s “conduit” attack on a Dutch holding company through which U. K. and Swedish shareholders organized their Canadian subsidiary. The tax court recognized the Dutch company as the “beneficial owner” of dividends paid from Canada, because it maintained discretion and the right of independent action as to the use of those funds. This allowed the Canadian company to withhold taxes at a reduced rate under the Canada-Netherlands treaty.

In the American Income Life Insurance Co. and Knights of Columbus decisions, the tax court upheld two U. S. insurers’ claims for the “business-profits exemption” in the Canada-U. S. tax treaty on the basis that the insurers did not have permanent establishments in Canada. These cases provide critical insight on the application by Canada of the “permanent establishment” concept to non-resident enterprises that solicit sales in Canada through Canadian-based sales representatives. They also offer guidance on factors that result in a foreign enterprise having a fixed place of business in Canada, which can affect international reorganizations.

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