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Protocol to Amend the Canada - U.K. Tax Treaty

Tax Bulletin

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After nearly three years of negotiation, an agreement has been reached to amend the Canada - United Kingdom Tax Convention (the "Treaty"). The process began in October, 2011 in Ottawa and was completed with the signing of a protocol amending the Treaty in London on July 21, 2014 (the "Protocol"). This agreement is the fourth protocol amending the Treaty which was originally signed on September 8, 1979 with the most recent prior protocol signed on May 7, 2003.

The Protocol contains sixteen articles amending the Treaty and also includes an "interpretative protocol" that governs the interpretation of certain terms used in the Treaty. This article will describe some highlights of the Protocol and comment on the impact of these provisions on cross-border tax issues between Canada and the U.K.

Partnerships

Under the Treaty, Article 3 (General Definitions) contains a definition of "person" that specifically excludes partnerships. The Protocol has amended this definition so that a partnership is now considered a person for purposes of the Treaty. This change will bring the Treaty more in line with the OECD Model Tax Convention (the "OECD Model Treaty").

In addition, the interpretation protocol includes a provision that applies to U.K. limited liability partnerships ("UK LLPs"). A UK LLP is a slightly unusual entity because, as a matter of general law it is constituted as a "body corporate" yet while it carries on a trade, profession or business with a view to profit its activities are generally treated as being carried on by its members (rather than the UK LLP itself) albeit that this "transparent" treatment does not apply, for example, on a winding up of a UK LLP. Against this backdrop, the interpretation protocol states that the income or gains of a UK LLP which, has its effective management in the UK and is fiscally transparent for UK tax purposes will be treated as income or gains of the members of the LLP but only to the extent that the income or gains are treated, for UK tax purposes, as income or gain of a UK resident. One implication of this interpretative provision is that a UK LLP might otherwise be considered a corporation for Canadian tax purposes notwithstanding that it may be fiscally transparent for UK tax purposes; indeed, we understand that the Canada Revenue Agency, Rulings Directorate may have reached this conclusion in connection with an advance tax ruling request. The interpretation protocol provides for the Canada Revenue Agency and HM Revenue and Customs to consult to determine the application of the paragraph and so taxpayers will need to be mindful of the uncertainty which arises where the application of a treaty may ultimately depend upon

discussions between fiscal authorities to which the taxpayer is not a party.

Corporate Residence

The Protocol also amends Article 4 (Residence) by adding "place of incorporation" as a reason that a person may be liable to tax and thereby considered a resident of a Contracting State. Unfortunately, the Protocol did not add a corporate residency "tie breaker" rule like paragraph 3 of Article IV in the Canada-U.S. Tax Treaty (the "US Treaty") that deems a company that is otherwise resident in both Contracting States to be a resident only in the Contracting State where it is incorporated. Tie-breaker rules provide greater certainty for taxpayers relying on the availability treaty benefits.

Business Profits

The current "Business Profits" article in the Treaty is largely identical to the pre-2010 OECD Model Treaty and the Protocol replaces this article with a new version that is generally the same as the "Business Profits" article in the 2010 OECD Model Treaty.

Associated Enterprises

The provisions of the Treaty that are intended to apply to avoid double taxation in the context of a transfer pricing adjustment were also modified by the Protocol. In particular, the current requirement to notify competent authority within six years from the end of the taxation year (Canada) or chargeable period (UK) to which the adjustment relates has been deleted. Instead, the Protocol provides that a Contracting State cannot make a "primary adjustment" to the profits of an enterprise after eight years from the end of the relevant taxable year. Because the Protocol is silent about "secondary adjustments" (i.e. the assessment of withholding taxes imposed on the non-resident as a consequence of the transfer pricing adjustment to the resident taxpayer), it appears that a Contracting State is not restricted by any time limit under the Treaty in respect of assessing secondary adjustments.

The use of the term "primary adjustment" in Canada's tax treaties first appeared in the recent Canada-Hong Kong Tax Treaty and may now be part of Canada's tax treaty policy. The time limits applicable to secondary adjustments under the Canada-Luxembourg Tax Treaty were recently considered in *McKesson Canada Corporation v. The Queen*.[1]

Interest

The Protocol replaces Article 11 (Interest) in its entirety. The most significant change is the introduction of an exemption from tax on interest arising in a Contracting State that is paid to a resident of the other Contracting where the recipient is the beneficial owner of the interest and deals at arm's length with the payer.

A significant limitation on the scope of this exemption is imposed by the interpretative protocol which provides that:

- for Canadian purposes, whether persons are dealing at arm's length is to be determined by subsection 251(1) of the *Income Tax Act* (Canada); and
- for UK purposes, persons are considered not to be dealing at arm's length if one person has "control" of another, persons are "associated" or "connected" for UK tax purposes, or (where there is no control, association, or connection) conditions are made or imposed between persons which do not reflect ordinary commercial dealing between persons acting in their separate interests.

Interestingly, this exemption appears to apply in circumstances a borrower pays interest in respect of a debt obligation where the owner of the debt obligation is related to the payer but the owner of the interest is arm's length to the borrower (e.g. where the owner of the interest holds stripped or coupon interest that is separate from the debt obligation). Under Canadian domestic law, such interest paid by a Canadian resident to an arm's length non-resident of Canada would otherwise be subject to Canadian withholding tax.

The exemption is also subject to an exclusion for participating interest where all or any portion of the interest is contingent or dependent on the use of or production from property or is computed by reference to revenue, profit, cash flow, commodity price or any other similar criterion or by reference to dividends paid or payable to shareholders of any class of shares of the capital stock of a company.

This concept is identical to the definition of "participating debt interest" in subsection 212 (3) of the *Income Tax Act* (Canada). As a result, interest that is "participating debt interest" paid by a Canadian debtor to a beneficial owner resident in the UK will be subject to a maximum rate of 10% under Article 11 of the Treaty. Notably, the US Treaty has a similar but somewhat narrower concept of participating interest in Article XI that applies the 15% withholding tax rate under Article X, applicable to dividends.

Recognized Pension Plans - Exempt Dividends

The Protocol provides for a new tax exemption for dividends. An amendment to Article 10 (Dividends) will exempt certain dividends from tax in the source Contracting State if such dividends are beneficially owned by an organisation that was constituted and operated in the other Contracting State exclusively to administer or provide benefits under one or more "recognized pension plans". To qualify for the exemption the following conditions must be satisfied: (a) the organisation must be exempt from tax in the other State and it must be the beneficial owner of the shares on which the dividends are paid and it must hold such shares as an investment; (b) the organization does not own directly or indirectly more than 10 per cent of the voting power of the company paying the dividends; and (c) each recognized pension plan provides benefits primarily to individuals who are resident of the other State. For these Canadian purposes, a recognized pension plan means a retirement or employee benefits plan described in paragraph (a) of the definition of "pension" under Article 5 of the *Income Tax Conventions Interpretation Act* (Canada).

This is a welcome addition to the Treaty that is similar to the exemption provided under Article XXI of the US Treaty.

Elimination of Double Taxation

The Protocol replaces paragraph 2 of Article 21 of the Treaty to accommodate the introduction of new 'exemption' regimes introduced by the UK (i) on July 1, 2009 in relation to distributions received by companies subject to UK corporation tax, and (ii) on July 19, 2011 (on an elective basis) with respect to the profits of a company's permanent establishments outside the UK.

The amended paragraph 2 provides for an exemption from UK tax for dividends paid by a Canadian resident company to a UK resident company when the exemption is applicable and the conditions for exemption under UK law are met.

Under UK law, the conditions which govern whether a distribution is exempt (or taxable) depend upon whether the recipient company is a "small company" or a "large

company". A small company is, generally, a company that has (i) no more than 50 employees, and either (ii) annual turnover of less than €10 million, or (iii) gross assets of less than €10 million. For a small company, an exemption is not available where (a) a distribution is comprised of interest which is re-categorised as a distribution under UK tax law, (b) a distribution is allowed as a deduction from taxable profits outside the UK, and/or (c) a distribution is paid as part of a "tax advantage scheme". A company that does not satisfy the "small company" requirements is a "large company" for these purposes, and for such a company there is a range of five exemptions which are effectively designed to confer exemption from UK tax other than where perceived tax avoidance is afoot.

Where a company is resident in the UK and has a permanent establishment situated in Canada, the amended paragraph 2 provides that the UK shall exempt the profits of that permanent establishment from UK tax where the exemption provided for by UK law is applicable and the conditions for exemption under UK law are met.

Mutual Agreement Procedure

The mutual agreement procedure ("MAP") under the Treaty was previously quite rudimentary. Under the Protocol, a more detailed MAP is introduced. For example, for taxpayers to benefit from the MAP under the Protocol, an application must be made within three years from the first notification of the action resulting in taxation not in accordance with the Treaty. No such time limit exists under the current Treaty.

Further, for purposes of Articles 6, 7 and 14 of the Treaty, the Protocol provides that a Contracting State shall not after eight years from the end of the taxable period to which the income concerned was attributed make a primary adjustment to the income of a resident of one Contracting State where that income has been charged to tax in the other Contracting State.

One of the most significant changes to the Treaty agreed to in the Protocol is a mandatory arbitration provision that will be used to assist with the successful resolution of MAP cases. Similar to the arbitration provisions in the US Treaty, this provision allows the competent authorities of Canada and the UK to submit to binding arbitration in situations where the competent authorities have been unable to reach an agreement to resolve a case under the MAP. Under the Protocol, the competent authorities have three years (or longer if agreed to by the competent authorities) from the date on which the information necessary to consider the issues raised has been received by both competent authorities. By contrast, the time period under the US Treaty is two years (or longer if agreed to by the competent authorities). Detailed rules and procedures for arbitrations will be agreed upon by Canada and the UK through an exchange of diplomatic notes.

Exchange of Information and Assistance in the Collection of Taxes

The Protocol replaces the existing Article 24 (Exchange of Information) with a comprehensive new article that embodies the latest OECD Model Treaty provisions. Similarly, new Article 24A is introduced by the Protocol which implements the OECD Model Treaty provisions relating to "Assistance in the Collection of Taxes". This replaces a very modest provision dealing with collection assistance provided in Article 27, paragraph 5 of the Treaty.

According to the Department of Finance press release announcing the signing of the Protocol, it is expected that the Protocol will generally apply beginning on January 1, 2015. This assumes that the Protocol is ratified by Parliament in Canada and the U.K. in

2014, as the Protocol provides that it will enter into force in respect of Canadian taxes on the first day of January in the calendar year following ratification.

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[1] 2013 TCC 404. The decision is under appeal to the Federal Court of Appeal.

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