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Blaney McMurtry
BARRISTERS & SOLICITORS LLP

Blaneys on Business

This newsletter is designed to bring news of changes to the law, new law, interesting deals and other matters of interest to our commercial clients and friends. We hope you will find it interesting, and welcome your comments.

Feel free to contact any of the lawyers who wrote or are quoted in these articles for more information, or call the head of our Corporate/Commercial group, Steve Popoff at 416.593.3972 or spopoff@blaney.com.

NEW TAX MEASURES SHOULD HELP KEEP CANADA ATTRACTIVE TO MAJOR U.S. INVESTORS

Paul L. Schnier

The first of several new tax measures that will help maintain Canada as an attractive investment destination and business location for major U.S. enterprise has taken effect and business people on both sides of the border are looking for the rest to be implemented sooner rather than later.

Under the first measure, which came into force January 1, Ottawa has stopped requiring that portions of interest payments that Canadian concerns make to *arm's length* investors in the U.S. and other foreign countries be withheld. For large capital pools, such as investment funds, which may have investors living in tax free jurisdictions, this may amount to as much as a 25 per cent increase on what these investors earn from some of their Canadian investments.

The withholding tax for *non*-arm's length investors in the United States is to be abolished, as well, in stages, beginning two months after the recently negotiated fifth protocol to the Canada – U.S. Tax Convention is ratified in both countries. (Under the convention, the withholding tax on dividend income is sustained.)

The new Canada-U.S. protocol will also help sustain Canada's attractiveness as an investment and business destination by providing more equitable tax treatment to U.S. limited liability companies (LLCs) and partnerships and by helping ease the implications of cross-border transfers of business executives. In addition, it will assure that Canada gets a fairer share of tax revenue from income that some U.S. residents earn in this country. Here are some of the details:

Withholding Tax on Interest

The new protocol eliminates withholding tax on interest payments made by residents of one country to arm's length parties who reside in the other country. (This does *not* apply to "participating interest," which is generally defined as interest that depends on the revenue or profits of the paying entity.) "Arm's length" is not a defined term but parties that are related are deemed *not* to be dealing at arm's length. The Canadian withholding tax on payments going to arm's length parties in the U.S. has been eliminated already by virtue of unilateral action by Ottawa last fall. The U.S. tax on such payments going to Canada is to be eliminated immediately when the new protocol becomes effective.

For *non* arm's length parties, there is a three year phase-in whereby the withholding tax on interest payments, currently 10%, would be reduced to 7% in the first year, 4% in the second year and zero after that.

Fiscally Transparent Entities

Under current administrative practice, the Canada Revenue Agency denies treaty benefits to U.S. LLCs, since they are not considered resident in the U.S. Also, members of U.S. partnerships are denied certain treaty benefits. The new protocol addresses these deficiencies by looking at the *members* of the LLCs or partnerships rather than the entities themselves. In other words, treaty benefits will be extended to members of LLCs or partnerships who are resident in the U.S.

In addition, the new protocol provides that there will be a "look through" for the ownership of shares as it pertains to withholding tax on dividends paid by Canadian companies. Under the current treaty, the 15% rate for withholding tax

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on dividends is reduced to 5% where the recipient is a corporation owning at least 10% of the stock of the paying Canadian company. Shares owned by LLCs or partnerships were formerly not regarded as being owned by their members and so the reduction to the 5% rate could not apply. Under the new protocol a corporate member of an LLC or partnership will be deemed to own its prorated share of the stock of the Canadian company and therefore will be in a position to qualify for the reduced rate.

Hybrid Entities

The term "hybrid entities" generally refers to entities that are taxed on one basis in Canada and on a different basis in the U.S. This is far more common in the U.S. than in Canada. For example, there are Canadian corporations that are taxed as corporations in Canada but may be taxed as partnerships or sole proprietorships in the U.S. Various complicated structures have been devised utilizing these entities in order to avoid or reduce taxation both in Canada and the U.S.

The new protocol provides that a hybrid entity will not be entitled to treaty benefits. Therefore, tax minimization strategies employing hybrids may no longer work. As a result, it will be necessary to review any cross border arrangements that have been put into place using hybrid entities to determine whether there might be substitute structures that could provide some tax benefits. For this reason, the implementation of this particular provision will be delayed to the first day of the third calendar year that ends after the protocol enters into force. This will mean sometime after the beginning of 2010.

Permanent Establishment

Under the current treaty, a U.S. resident carrying on business in Canada is not subject to tax in Canada unless that business is carried on through a "permanent establishment". The same applies to a resident of Canada carrying on business in the U.S. The term "permanent establishment" generally includes an office, a fixed place of business or an employee or agent other than an independent contractor. The term does not seem to capture residents of one country who provide services in the other country but *not* through a fixed place of business. Although regulations provide for withholding tax on payments for services, this withholding tax may be avoided by claiming that the income relates to a business which is carried on other than through a permanent establishment.

The new protocol deals with this issue by creating a new category of permanent establishment. When the protocol takes effect, a permanent establishment will also be deemed to exist for an entity if:

(a) services are performed by an individual who is present in the other country for 183 days or more in any 12 month period and during such period, more than 50% of the entity's gross income for that period is derived from that revenue; or

(b) services are provided for 183 days or more in any 12 month period with respect to the same or a connected project for customers who are resident on the other side of the border.

What this means is that if a resident of one country (Canada or the U.S.) is providing services in the other country and either of these tests is met, the profits will now be taxable in that other country. This new rule lowers the threshold for taxing profits derived by a resident of one country who provides services in the other country.

"The federal government has recently approved amendments to Canada's anti-money laundering legislation and regulations that will affect the obligations of a wide range of entities..."

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Other Changes

The new protocol will also ease some of the historic constraints on cross-border transfers of executives and other business personnel by revising the treatment of contributions and benefits relating to certain retirement plans in order to facilitate cross-border movement of personnel; apportioning employee stock option benefits between Canada and the U.S.; preventing double taxation for emigrating Canadians on pre-emigration gains; and addressing cross-border distributions from Canadian income trusts and from U.S. REITs.

Most of the changes prescribed in the new protocol are scheduled to come into effect two months after it is ratified by both countries. In the first part of this year, business people were hoping that ratification would proceed expeditiously. But they were not holding their breaths. Given that this is a presidential election year in the United States and, through the early part of 2008, the federal government in Canada remained in a minority position, the elected people who had to do the ratifying certainly had other matters on their minds. ■

CHANGES TO CANADIAN ANTI-MONEY LAUNDERING REQUIREMENTS AFFECT OBLIGATIONS OF REPORTING ENTITIES

Kelly J. Morris and Jill E. McCutcheon

The federal government has recently enacted amendments to Canada's anti-money laundering legislation and regulations that will affect the obligations of a wide range of entities, including financial institutions, life insurance companies, securities dealers, foreign exchange dealers, money exchange businesses, real estate brokers, accountants and casinos, all of which are reporting entities under the legislation. The amendments, most of which are to come into force in June 2008, are designed to bring *The Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (the "Act") into compliance with new Financial Action Task Force ("FATF") standards designed to combat money laundering and terrorist financing internationally. The FATF is an international body made up of 34 member countries that is responsible for setting anti-money laundering and anti-terrorist financing standards.

The Act, which has been in force since 2000, imposes obligations on reporting entities that include mandatory reporting of suspicious transactions and holdings of terrorist property, record keeping and client identification requirements, reporting of certain large cash transactions and electronic funds transfers and requirements with respect to the implementation of a compliance regime.

The amendments to the Act include the establishment of administrative penalties that may be imposed by the Financial Transactions and Reports Analysis Centre of Canada ("FINTRAC"), Canada's financial intelligence unit, for minor, serious and very serious violations of the Act. The current Act only provides for penalties relating to knowing violations of the Act. The changes to the Act will allow FINTRAC to issue Notices of Violation and set penalties for such violations, which will include inadvertent violations of the Act.

Other key amendments to the Act and regulations include:

- **Shift to risk-based compliance system.** Reporting entities will be required to develop policies and procedures to assess the risk of their products being used for money laundering or terrorist financing purposes. If the risk assessment for a particular product is high, the

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reporting entity must take special measures to address that risk. Reporting entities will also be required to determine whether clients pose a higher than normal risk, and if so, will be required to conduct ongoing monitoring to determine if the client is engaged in transactions that there are reasonable grounds to suspect are related to the commission of a money laundering offence or terrorist financing activity ("suspicious transactions"), and must also take reasonable measures to keep the client information up to date.

- **Determination of "politically exposed foreign persons".** Reporting entities will be required to determine, in certain circumstances, whether their clients are "politically exposed foreign persons" ("PEFPs"), who are high-level government, military or judicial officials of a foreign country and their family members. PEFPS are considered to have potentially greater opportunities to engage in money laundering or terrorist financing activities. If a person is determined to be a PEFP, the reporting entity must take reasonable measures to determine the source of the funds received from the PEFP, and must perform ongoing monitoring of the account.
- **Mandatory ongoing compliance training program.** The requirements with respect to the mandatory compliance regime are being strengthened and will include provisions requiring reporting entities to develop and maintain a written ongoing compliance training program for their employees and agents, and to have their policies and procedures, risk assessment and training programs reviewed every two years, preferably by an internal or external auditor.
- **Required reporting of attempted suspicious transactions**. Reporting entities are currently required to file a suspicious transaction report only if the transaction is completed. When the amendments come into force, reporting entities will be required to report attempted suspicious transactions and to take reasonable measures to identify the individual conducting the transaction before filing a suspicious transaction report.
- **Changes to client identification requirements.** The new regulations establish detailed requirements for verifying client identity when the client is not physically present. In addition, if a reporting entity has doubts about the information it previously collected about an individual, it must identify the individual again.

Although many of the amendments impose increased compliance obligations on reporting entities, there are also some amendments that will facilitate compliance. For example, reporting entities will no longer be required to keep information that they already retain in other records. There will be a simplified identification process for individuals who are not physically present if a financial entity, securities dealer or life insurance company affiliated with the reporting entity has already identified the individual. Exemptions from the record keeping requirements will be expanded so that such records are not required where there are exemptions from the client identification requirements. ■

Blaneys on Business is a publication of the Business Law Department of Blaney McMurtry LLP. The information contained in this newsletter is intended to provide information and comment, in a general fashion, about recent cases and related practice points of interest. The information and views expressed are not intended to provide legal advice. For specific legal advice, please contact us.

We welcome your comments. Address changes, mailing instructions or requests for additional copies should be directed to Chris Jones at 416 593.7221 ext. 3030 or by email to cjones@blaney.com. Legal questions should be addressed to the specified author.

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