Ernst & Young Tax Services

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TAX ALERT

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New double taxation treaty with Canada enters into force

On 12 April 2005 a new double taxation agreement between Ireland and Canada entered into force. This agreement replaces an existing tax treaty that was signed in November 1966. The revised agreement will apply with effect from 1 January 2006.

The 1966 agreement pre-dated capital gains tax (CGT) and the modern income tax system. In this regard the new treaty will cover transactions subjected to CGT for the first time. In addition, new articles dealing with dividends, interest and royalties generally provide for lower withholding taxes than apply at present. On a less positive note certain tax exemptions will be removed and the tax credit available on Canadian dividends paid to Irish individuals will be substantially reduced.

Withholding Taxes

A comparison of withholding taxes between the new and old treaties can be made as follows:

Payments from	Dividends		Interest		Royalties	
	1966 Treaty	2003 Treaty	1966 Treaty	2003 Treaty	1966 Treaty	2003 Treaty
Canada	15/0	15/5**	15	10	15/0	0/10
Ireland	20*	15/5*	20***	10***	20	0/10

* While Dividend Withholding Tax (DWT) is permitted under the treaty, Irish domestic law provides that DWT normally does not apply
** Normally 15% but reduced to 5% where a company holds 10% of the voting power - 15% rate also applies to payments by Canadian non-resident owned investment corporations
***Under Irish domestic law withholding tax on trade interest payments to Canadian companies is usually eliminated

A minimum withholding tax of 5% may still apply to Canadian dividends. However, the conditions for obtaining this rate are less restrictive than those for accessing the zero rate under the old treaty. A welcome withholding tax exemption for dividends received on quoted shares by tax-exempt pension/employee benefit funds has also been introduced.

A key change will be the reduction in the rate of withholding tax on interest paid from Canada from 15% to 10%. Given the reduction in Irish corporation tax rates to 12.5% with effect from 1 January 2003 and the availability of a tax credit, the lower rate should make lending from Ireland to Canada somewhat more attractive. The new treaty also contains several new exemptions e.g. for interest on government/ local authority loans, where a withholding tax will no longer apply.

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Disclaimer

The 1966 agreement provides that copyright royalties and 'other like payments' made in respect of literary or dramatic works etc. are not subject to withholding taxes. All other royalties may be subject to a 15% withholding.

The new treaty provides that, as a general rule, royalties may be subjected to a withholding tax of up to 10%. However, most significantly, exemptions will exist for:

a) '*copyright royalties and other like payments in respect of the production or reproduction of any literary, dramatic, musical or artistic work (but not including royalties in respect of motion picture films nor royalties in respect of works on film or videotape or other means of reproduction for use in connection with television broadcasting)*' and

b) '*royalties for the use of, or the right to use, computer software or any patent or for information concerning industrial, commercial or scientific experience (but not including any such royalty in connection with a rental or franchise agreement)*'

Irish companies in receipt of royalties from Canada may wish to review existing and proposed licensing arrangements in light of the proposed elimination of Canadian withholding taxes on many forms of royalty payments made directly to Irish residents.

Under Irish domestic law, withholding tax (20%) only applies to royalties that constitute annual payments or that are in respect of the use of a patent. On the basis that most royalties do not constitute annual payments under Irish law, withholding tax primarily applies to patent royalties. The new treaty provides that the rate of withholding tax on patent royalties will fall from 20% to 0%.

Corporation Tax

Under Irish tax law, when interest is paid by an Irish company to a 75% non-resident affiliated company, the interest is treated as a distribution and is considered non-deductible for tax purposes. However, this treatment is relaxed for interest paid for trading purposes to a company resident in a tax treaty jurisdiction. The old Canada-Ireland treaty, like many of Ireland's older treaties, also overrode the reclassification through its language and the fact that it predated the introduction of corporation tax in Ireland. While a specific measure is often contained in the non-discrimination article of more recent treaties providing that interest should be deductible on the same basis as interest paid to Irish residents, this language is not reproduced in the non-discrimination article of the revised treaty. This should not cause problems where interest is paid for trading purposes but it may raise concerns where the interest is regarded as a 'charge on income'.

However, the Revenue Commissioners have tentatively indicated that the wording of the non-discrimination provision in the new treaty is sufficiently widely drawn to prevent the reclassification of interest paid to Canadian parent companies as a non-deductible distribution. The position of non-trade interest payments to other Canadian affiliated companies is less clear, although there are some grounds for also disapplying the reclassification rules in such circumstances. An Ernst & Young submission on this matter is being considered by the Revenue Commissioners.

The new treaty makes provision for a tax deduction for pension contributions paid by or on behalf of employees resident (or temporarily present) in one State e.g. Ireland, to pension plans recognised in the other State, e.g. Canada. The Canadian scheme contributions will be treated similarly to payments made to an Irish pension plan for the duration of the period of residence/ temporary presence of the employee provided this does not exceed 5 years, the Canadian pension plan corresponds sufficiently closely to an Irish pension scheme and the employee was contributing regularly to the Canadian plan immediately prior to taking up residence/ temporary presence in Ireland.

Another corporate measure in the new treaty is the dilution of the corporate residence tie-breaker provision to a situation where Canada and Ireland 'shall endeavour by mutual agreement' to settle the question of a company's corporate residence. There are also some alterations to the shipping and air transport article and some technical amendments to the permanent establishment provisions to align the wording with modern treaty practice.

Capital Gains Tax

Unlike the existing treaty the new agreement will apply to Irish CGT. A resident of Ireland who pays tax in Canada on a capital gain is currently not entitled to any credit for that tax against any Irish CGT arising on that capital gain. This will change with effect from 1 January 2006. Where double taxation is an issue, Irish taxpayers may wish to consider the timing of any planned disposals accordingly.

Personal Tax Issues

The old treaty contained a number of exemptions for various sources of income that have not been carried over into the new treaty. The two-year tax exemption for visiting researchers and teachers to universities or colleges will be discontinued.

A further change is the proposed taxation of pensions. The existing treaty requires Ireland and Canada to exempt periodic pension payments. Under the new provisions periodic pension payments (except war pensions) can be taxed in the country where the payments originate, subject to specified caps. Annuity payments may also be taxed in the source State subject to a 15% limit. As noted above employee contributions to Canadian/Irish pension plans will be deductible on the same basis as contributions to domestic pension plans provided certain conditions are met.

A very significant change affecting Irish individuals in receipt of Canadian dividends will be the reduction in the Canadian tax credit available for offset against Irish income tax. The existing agreement allows underlying taxes to be taken into account on Canadian dividends irrespective of the level of shareholding (the Revenue Commissioners currently allow a credit of 34%). Under the new agreement individuals (and indeed corporate portfolio investors i.e. those with less than 10% shareholding) will no longer be entitled to credit for underlying taxes. While, Irish companies owning 5% or more of Canadian companies may still be entitled to a credit for underlying taxes under Irish domestic provisions, individuals will not. An entitlement to a credit for withholding taxes only (15%) is likely to increase the Irish tax liability on Canadian dividend income.

General

The new treaty contains many more changes that are not addressed in detail in this tax alert. These include:

- Specific rules for offshore activities (typically oil and gas exploration);
- A special provision allowing for the rebasing of assets where an individual suffers an exit charge on transferring residence from one State to the other;
- A more comprehensive non-discrimination article;
- New mutual agreement procedures with time limits for notification;
- A more widely drawn entertainers/ sportspersons article that now extends taxing rights to payments made to companies owned by such persons that derive from personal activities exercised in either Canada or Ireland;
- Technical amendments to the Government service article;
- A provision allowing the imposition of a 5% ‘additional tax’ on branch profits of companies (subject to limits and certain deductions);
- An ‘other income’ article that, like the old treaty, departs from the more usual Irish treaty practice. It allows ‘other income’ derived from sources in either Canada or Ireland to be taxed in the country in which it arises subject to a 15% cap for income from an estate or certain trusts.

Conclusions

The radical overhaul of the Ireland/Canada double taxation agreement and the absence of any transitional provisions will require those involved in Irish/Canadian transactions to consider the implications of the new agreement very carefully prior to its implementation date of 1 January 2006.

Companies and individuals may wish to examine proposed transactions or payments with a view to establishing if a more beneficial treatment could apply by deferring or accelerating transactions or payments.