

Fifth Protocol to the Canada-U.S. Income Tax Treaty—Reflections

The fifth Protocol to the Canada-U.S. Income Tax Convention (Treaty) was signed on September 21, 2007. This *Tax Memo* reflects on the effect the Protocol will have on Canadian multinationals with U.S. operations, U.S. multinationals with operations in Canada and on certain individuals. Another *Tax Memo*, "Canada-U.S. Income Tax Treaty: Fifth Protocol Makes Major Changes," released on September 24, 2007, outlines the Protocol's key changes and its entry into force.

Table of Contents

International Tax	1	Personal Tax	24
Limited Liability Companies—Treaty Article IV(6)	1	Independent Personal Services Deemed	
Hybrid Entities—Treaty Article IV(7)	5	Permanent Establishment—Treaty Article V	24
New Challenges for Service Providers		Canadian Residency Termination: Deemed	
—Treaty Article V	9	Disposition—Treaty Article XIII	24
Withholdings on Dividends—Treaty Article X	11	Taxable Canadian Property—Treaty Article XIII	25
Withholdings on Interest—Treaty Article XI	12	Income from Employment—Treaty Article XV	25
New Bilateral Limitation on Benefits Rule		Stock Options—Treaty Articles XV and XXIV	26
—Treaty Article XXIX A	14	Pensions and Annuities—Treaty Article XXVIII	26
Accounting Implications	20	Students—Treaty Article XX	27
Transfer Pricing	21	U.S. Expatriation—Treaty Article XXIX	27
Attributing Profits to a Permanent Establishment		PricewaterhouseCoopers Contacts	28, 29
—Treaty Article VII	21		
Arbitration—Treaty Article XXVI	21		

International Tax

Limited Liability Companies—Treaty Article IV(6)

Historical treatment

The Canada Revenue Agency (CRA) has long considered limited liability companies (LLCs) created under U.S. state law to be corporations. If an LLC is treated as a disregarded entity or partnership for U.S. tax purposes, the LLC would not be subject to U.S. federal tax directly.¹ As a result, the CRA has indicated that it would not treat such an LLC as a resident of the U.S. for Treaty purposes. The CRA considered this the appropriate interpretation of the rules even if the LLC owners were themselves resident in the U.S. and subject to U.S. income tax on their share of the LLC's income.

1. An entity that is treated as a corporation for Canadian tax purposes, but is disregarded or treated as a partnership for U.S. tax purposes is generically referred to as a hybrid entity.

This position significantly increased the cost of using an LLC to invest into Canada by causing:

- payments of dividends, interest and royalties made to LLCs to be subject to a 25% withholding rate rather than to the treaty reduced rates ranging from 0% to 15%;
- LLCs realizing gains from the sale of stock in private Canadian companies that did not derive their value primarily from Canadian real estate to be subject to Canadian income tax rather than being exempt from tax under the Treaty; and
- LLCs carrying on business in Canada to be subject to Canadian income tax even though the LLC may not have maintained a permanent establishment (PE) in Canada.²

As a result, even though LLCs are commonly used investment vehicles to avoid U.S. double tax problems, U.S. investors have not been able to use LLCs to invest into Canada on a tax efficient basis. Given the significant use of LLCs by U.S. investors and, in particular, U.S. private equity funds, these consequences were significant impediments to U.S. investors making investments into Canada.

For U.S. individual investors, the solution to the problems created by LLCs was to form a U.S. corporation that elected under subchapter S of the Internal Revenue Code (referred to as an "S Corporation") to hold or invest directly into Canada. S Corporations provided similar flow-through consequences to U.S. investors as LLCs, but the CRA concluded that, unlike LLCs, S Corporations would be considered resident in the United States for treaty purposes. The CRA reached this conclusion because S Corporations are corporations formed under state law whose shareholders have elected to treat them as flow-through entities. Notwithstanding this election, an S Corporation would be subject to U.S. tax on its worldwide income if certain conditions for electing were not met. As well, an S Corporation may be taxed on certain types of income. This position can be contrasted with the CRA's position regarding LLCs that are automatically treated as a flow-through entity unless they elect to be taxed as a corporation. However, unlike the S Corporation, no specific requirements must be met and maintained for the LLC to remain a flow-through entity.

To avoid the tax cost created by investing in Canada through an LLC, many private equity funds structured their

investment in Canada through other countries, such as Luxembourg, to gain access to a favourable Treaty. However, such a structure adds to the cost of investing in Canada and it is likely that some funds have simply decided in the past not to invest in Canada because of the CRA's position on LLCs.

Of course, if the LLC was not considered resident of the United States for treaty purposes, an LLC with its mind and management in Canada could not use the Treaty's residency tie-breaking rules to be treated as a U.S. resident. LLCs that inadvertently maintained their mind and management in Canada could be subject to Canadian income tax on their worldwide income, with no credit for the taxes paid by their owners. As a result, Canadians using LLCs to invest into the United States had to ensure that the LLC maintained its mind and management in the United States or risk the income earned through the LLC being subject to double tax.

The Protocol

General requirements

As previously announced in the 2007 federal budget, the Protocol addresses U.S. residents that use LLCs to invest in Canada. However, rather than having a provision that directly addressed LLCs, the Protocol adds paragraph 6 to Article IV of the Treaty, which may be applied to a much broader range of entities. Generally this paragraph states that income, profit or gain earned by an entity will be "derived by" a resident of Canada or the United States if, under the tax laws of the country in which the owner is resident:

- the owner derived the income, profit or gain through an entity (other than an entity resident in the source country);
- the entity receiving the funds is "fiscally transparent" under the laws of the home country; and
- the treatment of the income, profit or gain is the same as its treatment would be if the income, profit or gain had been derived directly by the owner.

Although the wording is brief and awkward, it appears that for this provision to apply, the owner of the entity must be a resident of either Canada or the United States. Presumably, the Department of Finance developed rules that look through hybrid entities (such as LLCs) to determine whether the income earned (as opposed to the entity itself) was entitled to treaty benefits, to prevent non-U.S. owners of a hybrid entity from using the entity to reduce or eliminate Canadian tax on their share of the

2. Similar complications could result when a Canadian person used a Canadian partnership that elected to be treated as a corporation for U.S. tax purposes to invest in the United States, although this approach is less commonly used than LLCs.

income earned while completely avoiding U.S. tax on the income.

Concerns presented by the Protocol

Definition of “fiscally transparent”

One problem in determining whether an entity is “fiscally transparent” is that this term is not defined under the Treaty and is not commonly used in Canadian tax law. The term has been developed in the United States through regulations to assist in determining whether an owner of an entity would be entitled to claim treaty benefits on payments made to the entity. Although not defined under the Treaty, it is expected that a fiscally transparent entity would be an entity that is not subject to direct tax in the jurisdiction in which the owner is resident. It is hoped that applying this concept to an LLC that is treated as either a disregarded entity or a partnership for U.S. purposes will not be problematic.

Although determining whether an LLC that is treated as a partnership for U.S. tax purposes is fiscally transparent may not be controversial, it is not clear how this term would apply to other entities. A similarly worded provision in the U.S. Model Income Tax Convention indicates that this provision is intended to apply to LLCs, partnerships and grantor trusts.

For example, consider whether these rules would apply to income earned by a Canadian-resident individual who is a beneficiary of a trust not resident in Canada or the United States. If the trust received U.S. source interest income that it discretionarily allocated out to the Canadian beneficiary, would the trust be considered “fiscally transparent”? Would the answer to this question change if the trust deed required the interest income to be allocated to the Canadian beneficiary? What if the trust was required to distribute all of its income to the Canadian beneficiary? Because the term fiscally transparent has not been clearly defined in the Treaty, the answer to these questions is not entirely clear.

Treatment of income, profit or gain

Another problem in applying this provision relates to the treatment of the income, profit or gain earned by the entity. The provision clearly states that the income, profit or gain earned by the entity must be treated “the same as its treatment would be” if it was earned directly by the owner. Depending on the type of income earned and the type of entity used, it is possible that although the income may flow through to the owner, the characterization or treatment of the income may not be the same as if it were

earned directly by the owner. To ensure that these benefits are obtained, taxpayers will need to understand the tax consequences of the income flowing through the hybrid entity.

Application of the test in specific circumstances

Some of the issues that arise in the application of this provision to specific structures are outlined further in the following examples.

Reduced rate of withholdings on dividends paid to U.S. hybrid entities (LLCs)

Assume an LLC is owned 100% by a U.S. resident individual. The LLC has not elected to be treated as a corporation and, as a result, is treated as a disregarded entity for U.S. tax purposes. If the LLC owned 100% of a Canadian limited company and the Canadian company paid a dividend to the LLC, what rate of withholding tax would apply to the dividend payment?

It appears that under the Protocol the dividend would be treated as “derived by a person who is a resident” of the United States. However, the dividend is actually being paid to the LLC, which is treated as a corporation for Canadian tax purposes. As a result, should the dividend be subject to a 15% withholding tax as it is attributable to the U.S. individual? Alternatively, does the dividend simply qualify for a reduced rate of withholding under the Treaty and therefore, because the LLC is considered a corporation for Canadian tax purposes and owns 100% of the Canadian company paying the dividend, should the reduced 5% withholding tax rate apply to the dividend? The amendment to Article X (2)(a), discussed below, which allows a Canadian payer to look through an LLC to determine if the LLC’s owner holds at least 10% of the voting stock, applies only to corporate owners of LLCs; not to individual owners.

Assume instead that the entity owned by the U.S. resident individual was an S Corporation. Under the CRA’s current interpretations, the dividend paid to the S Corporation would be eligible for the reduced 5% withholding tax. However, it can be argued that an S Corporation could be considered fiscally transparent. If this were the case, it appears that the amendments would also apply to the dividend paid from the Canadian company to the S Corporation. If so, the same issue as to the appropriate rate of withholding tax to be applied on the dividend would arise. If the amendments in the Protocol result in the dividend’s being attributable and taxed as if it were earned

directly by the U.S. individual, this provision could increase the rate of Canadian withholding tax on dividends paid to S Corporations from 5% to 15%.

Another problem in applying the withholding rules to payments made to LLCs with multiple owners is how the payer will be able to determine whether each member of an LLC qualifies for treaty benefits. Under both Canadian and U.S. legislation the payer of an amount subject to withholding tax is generally responsible for remitting the tax to the government, and the payer is also liable for any deficiency in the amount withheld. Unlike the United States, Canada does not have prescribed rules regarding the information that needs to be obtained from a non-resident person in order to allow the payer to reduce the rate of withholding tax on a payment while avoiding interest, penalties and deficiency assessments for amounts underwithheld.

Generally, the CRA has administratively allowed the payer to accept the name and address of the payee as being the beneficial owner unless there is reasonable cause to suspect otherwise. When the payee is not the beneficial owner of the interest, a certification from the beneficial owner must be obtained. When a payer is making a payment subject to withholding taxes to an LLC, guidance will need to be provided as to what information the payer must obtain in order to ensure that the withholdings are appropriate. If the LLC is widely held (such as many U.S. private equity funds) it is unclear whether the LLC would be willing or able to provide sufficient information to the payer to allow them to determine the reduced rate on the payment.³ If this information was not provided, the payer may decide to withhold at the Canadian domestic rate and have the LLC deal with the Canadian tax authorities to recover the amount overwithheld.

Carrying on a business in Canada by U.S. hybrid entities (LLCs)

Assume an LLC is owned 50% by a U.S. resident individual and 50% by a non-resident of Canada or the United States. The LLC has not elected to be treated as a corporation, and as a result is treated as a partnership for U.S. tax purposes. If the LLC carried on a business through a permanent establishment in Canada, how would the business income be taxed under the Treaty?

In this instance, half of the income earned by the LLC would be treated as “derived by a person who is resident” of the United States. For Canadian tax purposes because the LLC is treated as a corporation that has earned the income directly, it is unclear what filings should occur to pay the Canadian tax on the income. For example, should the U.S.-resident individual file a Canadian personal tax return reporting and paying tax on his or her share of the income? Should the LLC file a Canadian corporate income tax return reporting all of the income earned, but claiming treaty benefits (such as the reduced rate of branch tax) for only half of the income earned by the LLC? Either alternative would significantly affect the amount of tax paid with respect to the Canadian branch income.

Assume instead that the entity was an S Corporation and was owned by a U.S. resident individual. Under the CRA's current interpretations, the S Corporation would file a Canadian corporate tax return but claim a treaty reduced 5% branch profits tax. However, because it can be argued that the amendments would also apply to the income earned by the S Corporation, the issue of who should file the tax return would also arise. If the amendments to the Protocol resulted in the individual filing a Canadian personal tax return to report the income, the Canadian tax on the income would increase while the branch profits tax on the income would be eliminated. Again, this could significantly increase the tax paid on the S Corporation's Canadian branch income.

In both of the previous examples, it is interesting to note that if the U.S. owner of the LLC (or S Corporation) is treated as “deriving” the income earned by the LLC and thus required to report the income attributed to the owner on a tax return filed by the owner, there is no corresponding provision that deems the owner to maintain a permanent establishment in Canada. As a result, if the business income is attributed to the owner and the owner is the person subject to tax on the income, as the LLC's permanent establishment has not been attributed to the owner, the owner may take the position that they are not subject to Canadian tax on the business profits. From these examples, it is clear that further guidance will need to be provided by the tax authorities as to how this provision should be interpreted with respect to a hybrid entity that carries on business through a permanent establishment located in the other country.

Disposition of taxable Canadian property by U.S. hybrid entities (LLCs)

Assume a U.S. private equity fund is established as an LLC and is owned by a number of investors. The LLC has

3. A similar issue currently exists when foreign investors invest in Canada through partnerships. However, widely held partnerships may be relatively limited as compared to the potential number of widely held LLCs.

not elected to be treated as a corporation and, as a result, is treated as a partnership for U.S. tax purposes. The LLC owned shares in a private Canadian company that did not derive more than 50% of its value from Canadian real estate. If the LLC sold the shares in the Canadian company for a substantial gain, how would the proceeds from the sale be taxed?

Because the LLC is treated as a partnership for U.S. tax purposes, if the owners of the LLC qualify for treaty benefits and the LLC does not maintain a permanent establishment in Canada, the gain from the sale that is attributable to the owner should be exempt from Canadian tax. When the shares of the Canadian company are sold, a section 116 certificate would have to be obtained; otherwise the purchaser would be required to withhold 25% of the gross proceeds and remit it to the CRA. However, to obtain this benefit when filing for the section 116 clearance certificates, evidence would have to be submitted to the CRA to support the residency of each of the LLC owners. For an LLC that is widely held, gathering this information would take significant administrative work. Indeed, for many owners, the information may be unavailable.

As a result, although the owners of an LLC may technically be entitled to claim benefits under the Treaty, practically it may not be possible to obtain sufficient information on the owners to support the claim. Consequently U.S. equity funds may continue to use entities resident in third countries, such as Luxembourg, to invest in Canada or simply decide not to invest in Canada at all. In certain cases, the amendments may reduce the GAAR risk that U.S. LLCs face when using Luxembourg intermediaries to invest in Canadian companies.

Use of Canadian hybrid entities

Canadian investors may use Canadian hybrid entities to invest into the U.S., although these are less common than U.S. hybrids. For example, Canadian investors could use a partnership formed under Canadian law that has checked-the-box to be treated as a corporation for U.S. tax purposes. This entity has been used in the past to simplify U.S. withholding tax requirements and to plan for U.S. estate tax. However, these structures have received limited use because of the concern that if the entity earned income through a U.S. permanent establishment, it would not be eligible for the reduced branch profits rate under the Treaty. These entities may become more widely used by Canadian investors because, depending on how

new paragraph 6 under the Protocol will be interpreted, it is expected that either:

- these entities should be entitled to claim the lower rate of branch profits tax directly; or
- the owners should be able to claim the reduced branch profits tax on income earned through a U.S. permanent establishment.

Issues not addressed by the Protocol

Although the Protocol did address issues concerning whether income earned by certain hybrid entities (such as LLCs owned by U.S. persons) would be entitled to treaty benefits, it did not amend the residency definition to allow an LLC to be considered to be resident of the U.S. As a result, it is critical that LLCs continue to carefully monitor the location of their mind and management to ensure that they are not inadvertently treated as a resident of Canada and taxed as a Canadian corporation.

Hybrid Entities—Treaty Article IV(7)

Historical treatment

No current treaty provisions deal specifically with hybrid entities (or “reverse hybrid entities”).⁴ Residents of either country deriving items of income from those entities currently enjoy treaty benefits. The Protocol introduces Article IV(7), which not only denies treaty benefits to eliminate cross-border tax arbitrage through the use of hybrid entities, but has additional implications.

The Protocol

Paragraph 7 is a more complex and far-reaching rule than the one-sentence provision in the 2006 U.S. model treaty designed to cover situations dealt with in both Treaty Articles IV(6) and (7). The paragraph’s full effect may not be known until the Department of Finance and the U.S. Treasury Department comment on its uncertainty.

As widely anticipated, paragraph 7 eliminates treaty benefits for so-called inbound “synthetic NROs” or “Canadian reverse hybrids” (as discussed below) but it goes a lot further. Paragraph (7) provides two treaty denial rules. Broadly, benefits are denied when a resident of one country derives or receives income, profit or gain:

- a) through an entity that is fiscally transparent under the tax laws of the source country, but not the recipient’s country, and is not resident in the recipient’s country,

4. An entity that is treated as a partnership for Canadian tax purposes, but as a corporation for U.S. tax purposes, is generically referred to as a reverse hybrid entity.

- if the tax treatment to the recipient in its country would be different had the income been earned directly and not through the entity; or
- b) from an entity that is fiscally transparent under the tax laws of the recipient's country, but not the source country and is a resident of the source country, if the tax treatment to the recipient in its country would be different had the entity not been a fiscally transparent entity under its country's tax laws.

The changes proposed by the Protocol pertaining to hybrid entities will apply beginning January 1, 2010 (at the earliest).

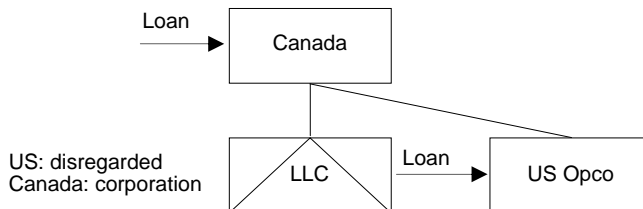
Outbound application

Paragraph 7 can be expected to adversely affect certain arrangements Canadian residents have used to invest in the United States. In particular, hybrid entities such as LLCs have been used by Canadian companies as operating entities in the U.S. and reverse hybrid entities have been used in the Tower Financing Structure. Non-U.S. hybrid entities, such as Barbados SRLs, have also been used to provide access to the permanent establishment article in the Canada-U.S. Treaty.

Operating hybrid entities

As illustrated in Figure 1, a Canadian corporation could own a U.S. LLC that earns interest income. If that interest income is not considered U.S. trade or business income, the U.S. normally would impose only a withholding tax on the gross interest paid. Paragraph 7(a) denies the treaty rate of withholding in this structure. While paragraph 7(a) incorporates the denial of benefits into the Treaty, the benefits relating to payments of passive income such as interest were denied under U.S. domestic law commencing in 2000, when the U.S. enacted Code section 894(c) as a treaty override.

Figure 1



What is not clear is whether paragraph 7(a) should apply if the LLC has only U.S. source trade or business income. In this scenario, business income would clearly be "profit"

as required in the preamble to paragraph 7(a). Would the U.S. say that the profit was "derived through an entity"? The plain meaning seems to support that interpretation, but the U.S. domestic provisions under Code section 894(c) do not apply to U.S. trade or business income and the U.S. model technical explanation sheds no light on the question. Accordingly, even though there may not be any cross-border arbitrage when the LLC carries on business in the U.S. through a permanent establishment, paragraph 7(a) applies to deny treaty benefits to a Canadian person that owns an LLC, or other disregarded entity, such as a Barbados SRL.

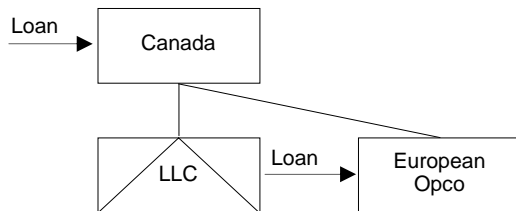
For instance, Canadian corporations often directly own LLCs that carry on operations in the U.S. through a permanent establishment.⁵ Because the LLC is disregarded for U.S. tax purposes, the U.S. taxes the Canadian corporation as though it operated a U.S. branch, including the application of the branch profits tax, which is generally reduced to 5% under the Treaty. In such cases, it appears that paragraph 7(a) will result in a denial of treaty benefits because the Canadian corporation will not be considered a resident of Canada. Accordingly, the branch profits tax will be levied at a rate of 30%.

Canadian corporations often hold intangible assets in offshore jurisdictions such as Barbados. In such cases, the Barbados subsidiary of a Canadian parent company may act as an entrepreneur, manufacturing products (generally via contract manufacturing arrangements) and selling those products to various foreign sister companies, including U.S. companies, which act as distributors in a country or region. When the Barbados subsidiary sells to a U.S. sister company, or even directly to U.S. unrelated customers, the Barbados subsidiary will often be set up as a Barbados SRL, which is disregarded for U.S. tax purposes. As a result, it is arguable that the Barbados SRL gains access to the Canadian treaty, because the U.S. disregards the Barbados SRL and considers the Canadian parent to be the company selling to U.S. customers. Access to the Treaty enables the Barbados SRL to stay out of the U.S. tax net, even if it has income effectively connected with a U.S. trade or business, provided that it avoids having a U.S. permanent establishment, which it is generally able to do. Paragraph 7(a) may well result in a denial of treaty benefits to the Barbados SRL.

5. In particular, this is the case if the Canadian company has significant debt financing and the U.S. interest allocation rules result in some of this interest being deducted for U.S. tax purposes.

Paragraph (7)(a) should not adversely affect US LLC financing structures (as illustrated in Figure 2) established by Canadian corporations to fund their other foreign operating companies (e.g., to finance European operations), because such interest would not be considered U.S. source and would therefore not be subject to withholding tax under U.S. domestic law.

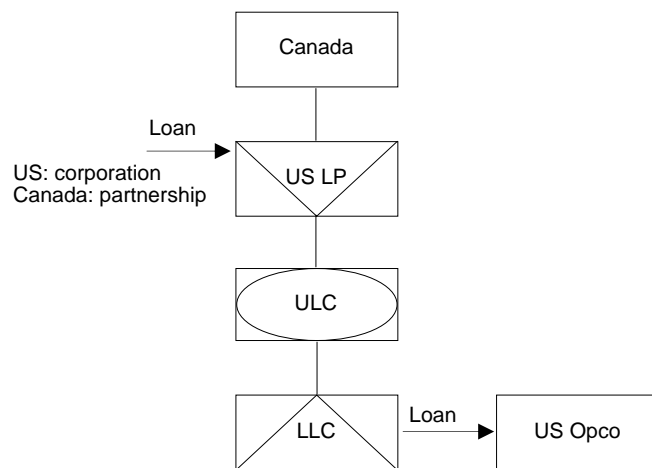
Figure 2



“Tower” structure

Paragraph (7)(b) can be expected to apply to so-called “Tower” structures, illustrated in Figure 3. Generally, a Tower structure involves the establishment of a U.S. partnership by Canadian corporate partners. The U.S. partnership is considered a reverse hybrid entity as a result of electing to be treated as a U.S. corporation for U.S. income tax purposes, but is treated as a Canadian partnership for Canadian income tax purposes. The U.S. partnership then borrows funds to contribute as equity, either directly or indirectly through a Canadian unlimited liability company (ULC), to a US LLC. The US LLC then uses the funds to finance either the operations of the U.S. subsidiaries of the Canadian corporation or the acquisition of a U.S. company.

Figure 3



In a typical Tower structure, the Canadian resident would receive as a payment a partnership distribution. For paragraph (7)(b) to apply, the “treatment test” must be met; i.e., the Canadian tax treatment of the distribution received must be different than if the U.S. hybrid owned by Canadian residents were an actual corporation in legal form. It is not clear what is meant by treatment, but on a plain reading partnership distributions are not income (they only reduce adjusted cost base), although a distribution from a corporation would typically be dividend income.

Accordingly, paragraph (7)(b) should apply to increase the 5% or 15% treaty withholding tax rate on distributions from Tower structures to the U.S. domestic rate of 30%. This will result in a marginal increase in the cost of using the Tower. However, this increase in the withholding tax rate will apply only when the U.S. partnership makes distributions to its Canadian corporate partners. If these distributions can be deferred, it may be possible to reorganize the Tower structure before making distributions to mitigate any extra cost that arises from the increased withholding tax. The changes proposed by the Protocol should neither affect the withholding tax rate on interest paid by the U.S. partnership nor impose a withholding tax on dividends paid by the LLC to its Canadian shareholders (i.e., the ULC).

Inbound application

The rules introduced in the Protocol to deny treaty benefits for payments to or by hybrid entities and reverse hybrid entities will significantly affect the manner in which U.S. corporations structure and finance their Canadian operations.

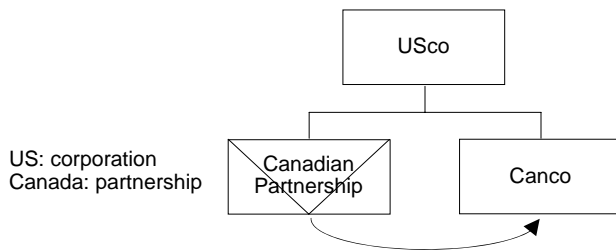
Reverse hybrid entities

One of the ways in which Canadian operations have been financed historically is through the use of reverse hybrid entities, the so-called “Synthetic NRO” structure.

“Synthetic NRO” structure

In the “Synthetic NRO” structure (illustrated in Figure 4), USco capitalizes a Canadian (or other non-U.S.) partnership with equity and elects to treat the partnership as a corporation for U.S. tax purposes. The partnership then makes a loan to the Canadian subsidiary. Under paragraph 7(a), interest payments to the partnership will be subject to the full rate of withholding tax of 25% as a result of the partnership’s being treated as a reverse hybrid entity.

Figure 4



Moreover, if the reverse hybrid entity owns shares of the Canadian subsidiary, it appears that dividend payments made by the Canadian subsidiary to the partnership would also be subject to withholding tax of 25%.⁶ A subsequent distribution of the dividend proceeds to the U.S. partners would be taxed in the United States. While this cross-border distribution would not be subject to Canadian withholding tax, the new Protocol does not contain any relieving mechanism to reduce the 25% withholding tax on the original dividend payment to the partnership that the U.S. parent will include in its income as a “dividend” received from the Canadian partnership. Although USco may be able to use the withholding tax as a foreign tax credit, there may still be significant tax leakage. Most importantly, the Protocol largely eliminates the tax deferral that was previously enjoyed by USco in such a structure.

The change to the treatment of reverse hybrid entities should not come as a surprise because the CRA had announced it was reviewing its policy⁷ on the treaty benefits extended to reverse hybrid entities in light of the recent OECD Commentary on this issue. As expected, the CRA chose not to change its administrative position with respect to treaty benefits for these structures. Instead, the changes have been reflected in the Protocol.

Unlimited liability companies

In contrast to the changes in the Protocol dealing with reverse hybrid entities, it was a surprise that amounts received by U.S. taxpayers from unlimited liability companies (ULCs) would be ineligible for the reduced rates of withholding under the Treaty. ULCs are used by U.S. taxpayers as operating companies, in financing structures and as holding companies, because they are “disregarded” for U.S. tax purposes.⁸

6. The 25% rate of withholding tax would apply notwithstanding the relieving changes in the Protocol clarifying the treatment of dividends paid to flow-through partnerships or LLCs.

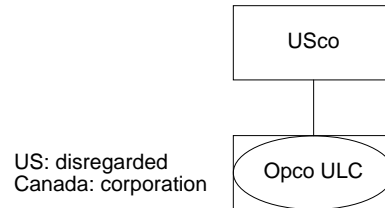
7. See CRA Access Letter 2003-0039051E5.

8. Unless elected to be treated as a corporation for U.S. tax purposes.

ULC as an operating company

As illustrated in Figure 5, many U.S. taxpayers use ULCs as the operating entity in Canada for state tax, start-up loss and foreign tax credit planning purposes.

Figure 5

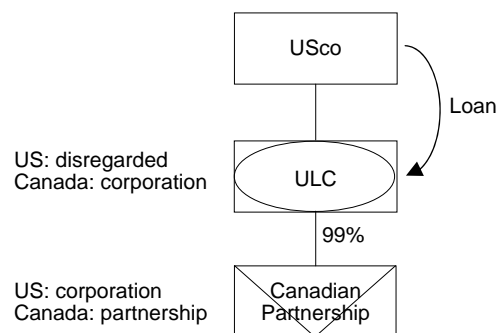


Although Opco ULC is a taxable Canadian corporation for Canadian tax purposes, it is treated as a Canadian branch of USco for U.S. tax purposes. Under paragraph 7(b), payments made by Opco ULC to USco that are subject to withholding tax (such as interest, royalties and dividends) will not be considered paid to a resident of the U.S., thus subjecting the payment to the full rate of withholding tax of 25%. In the case of dividends, this would be true notwithstanding that the income of Opco ULC is included in the income of the U.S. parent as branch income and has been fully taxed in Canada. Although the denial of treaty benefits for dividends paid by an operating ULC does not appear to be appropriate, the Protocol apparently applies to such dividends.

Hybrid entity financing structure

In a typical hybrid entity financing structure (illustrated in Figure 6), USco makes a loan to a subsidiary ULC, which also holds an interest in a partnership.

Figure 6



For Canadian tax purposes, interest paid on the loan offsets income allocated to the ULC by the partnership. For U.S. tax purposes, the interest income on the loan to the ULC is disregarded and income of the partnership is

taxed as a dividend, but only upon an actual distribution by the partnership. Accordingly, any income inclusion is deferred for U.S. tax purposes. Under paragraph 7(b), interest payments made by the ULC will be subject to 25% withholding tax, because USco does not recognize the interest income for U.S. tax purposes.

Dividends paid by ULC to USco will also be subject to 25% withholding tax under the new Protocol. In the above structure, this would be the case notwithstanding that the distribution from the partnership to the ULC would be taxable to USco as a dividend. If the ULC is used to hold shares of other Canadian and foreign subsidiaries, any dividends paid to the ULC will be viewed as dividend income to USco for U.S. tax purposes. Notwithstanding this dividend treatment, based on a strict reading of the Protocol, it appears the 25% withholding tax rate may apply to a subsequent dividend distribution by the ULC of the dividends it received.

Final observations

Paragraph 7(b) appears to apply only to payments from a resident of the source country, such as a Canadian ULC. Accordingly, it may still be possible to establish a hybrid entity in a foreign jurisdiction to avoid the application of paragraph 7(b). In addition, paragraph 7 does not generally affect structures that use hybrid instruments as opposed to hybrid entities.

The changes in the Protocol affecting hybrid and reverse hybrid entities have much broader implications than the denial of treaty benefits in the case of hybrid entity financing structures. In fact, we understand these measures may not have been intended to deny treaty benefits when ULCs are used as operating and holding companies. It remains to be seen, however, whether these unintended implications can be rectified by the two governments before the provisions become effective.

New Challenges for Service Providers —Treaty Article V

The Protocol contained a surprise addition to Article V that will directly affect U.S. businesses that perform services in Canada and Canadian businesses that perform services in the U.S.

Historical treatment

Consider a U.S. company (USco) that is clearly a "resident of the United States." for treaty purposes that will render services in Canada. Under the current Treaty,

USco would be subject to Canadian corporate tax on its profit attributable to providing services in Canada only if USco has a permanent establishment in Canada through which it carries on its business. For service providers, the analysis of whether a PE exists under the current Treaty would focus on whether there is a:

- "fixed place of business" (paragraph 1);
- one of a list of specific "places" (paragraph 2);
- building site or a construction or installation project (paragraph 3);
- dependent agent that habitually exercises an authority to conclude contracts in the name of USco (paragraph 5); or
- "preparatory and auxiliary activities" exemption even if a PE would otherwise exist (paragraph 6).

Often, USco can effectively manage its activities so that it would not have a PE under these provisions. Some guidance on the degree to which a service provider might be able to carry out activities in Canada for a significant time without establishing a taxable presence in Canada is provided by the Canadian Federal Court of Appeal (FCA) decision in **The Queen v. William A. Dudley**. In **Dudley**, the FCA concluded that, based on the facts, a non-resident consultant providing services at a client's premises in Canada (for more than 300 days in one of the calendar years in question) did not have a "fixed base" (conceptually the equivalent of a PE) at the client's premises. The principal issue was whether the taxpayer had "control" of the premises.

After the case was decided, the CRA grappled with the question of whether **Dudley** has broad application or whether it should apply only to situations with similar facts. The answer came with the issuance on December 5, 2005 of Transfer Pricing Memorandum TPM-08, "The Dudley Decision: Effects on Fixed Base or Permanent Establishment Audits and Regulation 105 Treaty-Based Waiver Guidelines." The memorandum provides a framework, presumably for use by the CRA's field auditors and appeals officers, for making PE determinations pursuant to the "general" definition of PE that is included in all of Canada's income tax treaties. In TPM-08, the CRA refers to the importance of distinguishing the facts of a particular PE case from those in **Dudley**.

The Protocol

The impetus for issuing TPM-08 was that a number of non-resident taxpayers had been relying, at least in part, on **Dudley** as support for why they did not have a PE in

Canada. It seems clear that amendments proposed by the Protocol will prevent U.S. residents from relying on **Dudney** when providing services in Canada.

In particular, Article III of the Protocol adds the following (as paragraph 9) to Article V:

Subject to paragraph 3, where an enterprise of a Contracting State provides services in the other Contracting State, if that enterprise is found not to have a permanent establishment in that other State by virtue of the preceding paragraphs of this Article, that enterprise shall be deemed to provide those services through a permanent establishment in that other State if and only if:

(a) Those services are performed in that other State by an individual who is present in that other State for a period or periods aggregating 183 days or more in any twelve-month period, and, during that period or periods, more than 50 percent of the gross active business revenues of the enterprise consists of income derived from the services performed in that other State by that individual; or

(b) The services are provided in that other State for an aggregate of 183 days or more in any twelve-month period with respect to the same or connected project⁹ for customers who are either residents of that other State or who maintain a permanent establishment in that other State and the services are provided in respect of that permanent establishment.

Other recently concluded Canadian treaties have similar provisions (e.g. the Canada-Mexico Treaty).¹⁰ Perhaps the amendments to Article V with respect to service providers will become standard in future treaties negotiated by Canada.

The preamble refers to an "enterprise of a Contracting State," a phrase not used in the present Treaty and not defined in the Protocol. However, the phrase is used and defined in some of Canada's recent treaties (e.g., the 2006 Canada-Korea Income Tax Convention and Protocol), in which case it means "an enterprise carried on by a resident of a Contracting State."

The intention of new paragraph 9 appears fairly clear: to address the current situation in which service providers that are not involved in a building, construction or installation project (still governed by paragraph 3) are able to spend a significant number of days physically present in Canada or the United States providing services, but without establishing a permanent establishment.

9. Annex B to the Convention (released at the same time as the Protocol) states that in this context "projects shall be considered to be connected if they constitute a coherent whole, commercially and geographically."

10. It is also similar to the sample provision included in the OECD draft commentary.

Subparagraph (a) appears to apply to situations in which one individual renders services in Canada or the United States either as a self-employed individual or as the key employee/shareholder of a corporation or other business entity. It does not matter whether that individual renders services to Canadian resident customers, but if the days of presence condition is met, to avoid having a PE, the revenue of the individual or the entity that pertains to the services rendered in Canada or the United States by the individual must be less than 50% of the total revenue.

Subparagraph (b) would apply to typical service provider situations. For example, USco would be deemed to have a PE if there were 183 days or more in any 12-month period in which services were provided with respect to the same "or connected" project for Canadian resident customers (or for non-Canadian resident customers that have a PE in Canada for which the services were performed). Typically, USco would provide such services through the actions of its employees and agents. It is not known yet whether the CRA or IRS might seek to count services provided by a subcontractor in determining whether the days of presence test is met.

New paragraph 9 has been added to the list of provisions in Article V that could be over-ridden by paragraph 6 (in respect of preparatory and auxiliary activities), but it is difficult to imagine many situations when there are personnel rendering services for more than 183 days that are restricted to the types of activities listed in paragraph 6.

Given the CRA's approach to PE issues for service providers in a "post-**Dudney**" world and the broad guidance in Annex B, one might expect the CRA to be aggressive in applying the concept of "same or connected project." For example, if USco sends a team of employees to Canada to help its new Canadian subsidiary start up operations or address key management issues and is paid a fee in respect of those services, and the 183-day test is met, one might conclude that the services are with respect to the same or connected project (even though they would be provided to a related Canadian company).

Given that this provision appears to have been initiated by Canada, it remains to be seen how aggressively the U.S. will pursue such activity. This provision has been grandfathered and will be effective no earlier than January 2010. In addition, periods of service before January 1, 2010 will not count in determining if new paragraph 9 is applicable. Accordingly, service providers will have a clean slate as of the end of calendar year 2009.

Of note with respect to the addition of paragraph 9 is the fact that no provision was added to the Treaty to address Regulation 105 of the *Income Tax Act* (Canada), which requires a withholding tax to be remitted by the payor of a payment made to a non-resident as a fee, commission or other amount in respect of services of any nature rendered in Canada. U.S.-based service providers were hoping for a provision in the Protocol that might override (at least partially) Canadian domestic law with respect to this withholding. However, such a change was not made, so the issues with Regulation 105 compliance remain. In fact, the limited withholding exception previously included in Article XVII has been eliminated.

No provision was added to the Treaty to provide some level of *de minimus* exemptions from Canadian payroll withholding obligations (under Regulation 102 of the *Income Tax Act*) in respect of salaries paid to employees who are residents of the U.S. but that perform employment duties in Canada. For further information regarding such issues, refer to the PwC *Tax Memo* dated May 12, 2006, "Withholding Tax Obligations on Remuneration Paid to Non-Residents of Canada," which is available on our Web site www.pwc.com/ca.

Withholdings on Dividends—Treaty Article X

Although recent treaties negotiated by the United States with other countries have eliminated withholding taxes on dividends, the current reduced rates on dividends are not changed by the Protocol. Dividend distributions made by a company resident in one country to a corporation resident in the other country will continue to be subject to a 5% withholding tax if the recipient corporation owns at least 10% of the voting stock of the distributing company. In all other cases, the maximum withholding tax applicable to dividends received by a person that qualifies for the benefits of the Treaty will be 15%.

A significant amendment introduced by the new Protocol is the look-through provision that will allow corporate members of a flow-through entity to benefit from the 5% reduced rate. The relevant portion of Subparagraph 2(a) of Treaty Article X, as amended by the Protocol, states:

...for this purpose, a company that is a resident of a Contracting State shall be considered to own the voting stock owned by an entity that is considered fiscally transparent under the laws of that State and that is not a resident of the Contracting State of which the company paying the dividends is a resident, in proportion to the company's ownership interest in that entity.

It is unclear how a company's proportionate interest in the flow-through entity will be determined. The criterion for determining whether a company can benefit from the 5% withholding rate is its interest in the voting stock of the subsidiary corporation. That makes it reasonable to expect that the proportionate ownership interest in the flow-through entity should also be based on the parent corporation's voting interest in the flow-through entity. However, in some entities, such as limited partnerships, ownership interests may not carry a specific voting right, and a fair-market value test may be more appropriate. Furthermore, ownership "interests" relating to income and capital may change over time.

In any event, this clause appears to allow U.S. corporate members of partnerships and LLCs to benefit from the 5% reduced rate of withholding when their indirect interest in the Canadian company exceeds the 10% threshold, provided that the entity through which they hold that investment is not considered to be resident in Canada under the terms of the Treaty. This resolves a long-standing issue under the existing Treaty and the resulting increased flexibility for structuring cross-boarder investments is welcome.

Another change of note to Article X is that the application of that article has been expanded with respect to distributions from U.S. REITs. Under the existing Treaty, only individuals who owned not more than a 10% interest in a U.S. REIT could benefit from the reduced treaty withholding tax rate of 15% on distributions. The Protocol provides that persons (including corporations) may benefit from the 15% rate if the REIT is either diversified or publicly traded. In the case of a diversified REIT, the person in question cannot own more than a 5% interest in the REIT. For publicly traded REITs, the ownership threshold is 10%. If these criteria are not met, the U.S. domestic withholding tax rate of 30% will apply to the distributions.

A final item of interest is that, according to the definitions in Annex B to the Convention, distributions from Canadian income trusts and royalty trusts will be treated as dividend distributions under the Treaty to the extent that they are treated as dividends under Canadian domestic law. Currently, distributions from these trusts to non-residents are not treated as dividend distributions under Canadian law. Instead, most distributions to non-residents from a trust are subject to withholding tax at 25% under part XIII of the *Income Tax Act* (reduced under Article XXII of the Treaty to 15%) and distributions from publicly traded trusts whose value is principally derived from Canadian

real or resource property that are not subject to Part XIII tax are taxed at a 15% rate under Part XIII.2 of the *Income Tax Act*.

Because the distributions are not dividends for domestic purposes and because Article XXI (Exempt Organizations) applies only to dividend or interest payments, the exemption from Canadian withholding tax under Article XXI of the Treaty did not eliminate withholdings on distributions from income and royalty trusts to U.S. pension funds. Under the “specified investment flow-through” (SIFT) trust rules, a distribution made by a SIFT trust to its investors is generally deemed to be a dividend for Canadian tax purposes to the extent that it is paid out of the trust’s earnings that have been subject to the tax under the SIFT rules. With the clarification provided by Annex B, the provisions of Article XXI should apply and distributions from Canadian income and royalty trusts should be tax-free to U.S. pension funds that qualify for the elimination of withholding tax under that article.

Withholdings on Interest—Treaty Article XI

As announced in the 2007 federal budget, the Protocol eliminates withholding tax on interest payments to unrelated persons, effective the second month after the date that the Protocol enters into force, but not before March 1, 2008.

Withholding taxes on interest paid or credited to related persons will be subject to a phased in elimination of the 10% withholding tax as follows:

- 7% during the first calendar year that ends after entry into force;
- 4% during the second calendar year that ends after entry into force; and
- 0% for subsequent years.

In addition, as announced in the 2007 federal budget the Department of Finance released draft legislation on October 2, 2007, that includes provisions that will exempt from tax any interest payments¹¹ that a Canadian resident makes to an arm’s length non-resident (i.e., including, but not limited to, U.S. residents). According to the draft legislation, this amendment will be effective on and after the first day on which the Treaty generally precludes Canada from taxing interest paid or credited to arm’s length U.S. residents. Depending on when the Protocol is

ratified, the effective date for this domestic tax change is likely to be sometime in 2008.

An amount that is considered contingent interest for U.S. income tax purposes and does not benefit from the portfolio interest exemption will be subject to a 15% withholding tax, as will participating interest payments from Canada to the United States (interest determined with reference to receipts, sales, income, profits or other cash flow of a change in value). An amendment to subsection 212(1) of the *Income Tax Act* was introduced with respect to these amounts as part of the draft legislation.

Along with the amendments to Article XI noted above, the Protocol modifies Article XXII (Other Income) to eliminate withholding tax on guarantee fees unless the profits for this activity are attributable to a permanent establishment in the other country.

Implications to Canadian borrowers

The ability to obtain nil withholding on interest paid to U.S. residents is currently limited to circumstances in which the Canadian domestic withholding exception in subparagraph 212(1)(b)(vii) of the *Income Tax Act* is available. In general terms, for this exception to be met the lender must be an arm’s length person and the Canadian borrower cannot be required to pay more than 25% of the principal of the debt in the first five years except for certain specific exemptions for default and other circumstances (referred to as the “5 year/25% restriction”). Access to a treaty-based exemption for unrelated U.S. lenders will likely have two benefits for Canadian corporations that look to the U.S. lending market:

- because the 5 year/25% restriction no longer has to be respected to obtain nil withholding, the Canadian borrower likely will be able to negotiate better terms with respect to borrowing and consider U.S. financial institutions and debt markets for “short” or medium-term financing.
- the expanded supply of potential lenders will increase competition and lower financing costs (i.e., potential lower interest and reduced fees with respect to the drafting of loan agreements due to the fact that the 5 year/25% restriction does not have to be included in the agreements).

Once the provisions included in the recently released draft legislation are effective, the number of potential lenders will increase further. In particular, Canadian subsidiaries

11. Other than “participating debt interest” as defined in the draft legislation.

of foreign multinationals may be able to borrow under globally negotiated financing arrangements with foreign banking syndicates. Depending on the financial situation of the group, this may allow for a higher level of debt in Canada, because that debt is not subject to the thin capitalization restrictions when the debt is not owing to a “specified non-resident shareholder.”

If the elimination of withholding tax increases the amount of debt that U.S. multinationals use to leverage their Canadian subsidiaries, it is possible that the Department of Finance will review the thin capitalization provisions and, if necessary, recommend changes. Amendments to the thin capitalization rules in the next couple of years would not be a surprise, especially if more Canadian treaties eliminate withholding tax on interest paid to related parties.

Implications to U.S. borrowers

U.S. domestic law currently provides an exemption for withholding tax on interest paid to non-U.S. lenders under the portfolio interest exemption. However, the Protocol still provides additional benefits, because the U.S. portfolio interest exception does not apply when the lender is a bank or a “10% shareholder” of the borrower. In addition, the portfolio interest exception requires that the debt instrument is either registered or in bearer form.

Accordingly, the Protocol will reduce the cost of U.S. companies borrowing from Canadian banks and related lenders. It may also reduce the administrative burden created when the debt instrument is required to be registered or in bearer form. However, consistent with the portfolio interest exception and as noted above, the Protocol does not provide for a nil withholding tax rate on contingent interest, but does reduce the withholding tax rate on contingent interest to 15%.

Because the interest withholding tax provisions, when fully phased in, will provide for nil withholding tax on interest paid by a U.S. payer to related Canadian residents, companies may have a bias toward debt over equity investments in U.S. subsidiaries of Canadian multinationals.¹² In most cases, there is a rate arbitrage benefit associated with lending into the United States due to a slightly higher corporate tax rate in the United States than in Canada. Historically, this tax rate advantage was eliminated or even resulted in an absolute cost if the withholding taxes could not be fully credited under the

Canadian foreign tax credit rules. This was often the case when the Canadian multinational borrowed to lend to its U.S. subsidiary.

The nil withholding rate will also be beneficial when Canadian multinationals finance their U.S. subsidiaries through offshore finance companies, such as those currently based in Hungary and Poland. Under the current Treaty, there may be an additional cost to an offshore financing structure when the Canadian multinational borrows to capitalize the offshore finance company, which in turn lends the funds to its U.S. sister company. In that situation, the interest payments made by the U.S. company to the offshore finance company are at risk of being subject to the U.S. anti-conduit rules (i.e., domestic anti-treaty-shopping rules), which may result in the application of the 10% withholding tax exigible under the current Treaty.¹³

Under the Protocol, cross-border interest payments that may have been subject to the 10% withholding tax rate due to the anti-conduit rules should be exempt from withholding tax. Further, even if an offshore financing structure is still considered a conduit, the anti-conduit rules would simply require application of the treaty rate, which is nil under the Protocol.

Perhaps the most significant benefit provided by the Protocol is that it increases the number of jurisdictions in which offshore financing companies might be located. In particular, most U.S. treaties include Limitation on Benefits (LOB) (i.e., anti-treaty-shopping) clauses that currently limit the jurisdictions that may be used for such purposes to those U.S. treaty countries that do not contain LOB clauses (e.g., Hungary and Poland). However, the elimination of withholding tax in the Treaty may preclude the application of the LOB clause in many cases where offshore finance companies are used to finance U.S. subsidiaries because of the derivative benefits exception that is generally included in the LOB clause.¹⁴

Under the derivative benefits exception, the nil withholding rate on interest paid to an offshore financing company by a U.S. resident will still be available if the withholding rate is not less than that which would be paid to the offshore finance company’s parent, provided that certain other

12. However, the U.S. has debt recharacterization rules that may limit the amount of debt that can be used to lever a U.S. subsidiary.

13. A similar risk exists when the offshore finance company pays dividends immediately upon receipt of its interest income, even if the Canadian multinational has not borrowed to capitalize the offshore company.

14. The effect of the proposals included in draft legislation released by the Department of Finance on October 2, 2007, will also have to be considered.

criteria are satisfied.¹⁵ One criterion, known as the base erosion test, generally requires that the amount of the expenses deductible by the offshore finance company that are paid to certain non-qualifying persons cannot be greater than 50% of the company's gross income. Accordingly, a question arises as to whether those offshore treaty companies that rely on a foreign branch to reduce the offshore jurisdiction tax on the interest income will qualify under the derivative benefits exception.

The elimination of withholding tax should also mitigate any concerns that might arise as a result of a recent bill presented by Rep. Doggett (D-Texas) that effectively proposes to introduce an LOB clause under U.S. domestic legislation.

It is difficult to envision a situation in which elimination of cross-border withholding tax results in a disadvantage to taxpayers. However, this is the case under the United States earnings stripping rules when Canadian multinationals lend directly to their U.S. subsidiaries.

If a corporation's capital structure is high in debt, the earnings stripping rules disallow the deduction of so-called disqualified interest, to the extent of the corporation's excess interest expense for the taxable year. Disqualified interest is generally defined as any interest paid or accrued to a related person if no U.S. income tax (including withholding tax) is imposed with respect to that interest.

Accordingly, a nil withholding tax rate on interest will subject U.S. related borrowers to additional disqualified interest that may be disallowed as a deduction in computing taxable income under the earnings stripping rules.

New Bilateral Limitation on Benefits Rule—Treaty Article XXIX A

The fifth Protocol entirely replaces the Limitation on Benefits (LOB) article of the Treaty with a new LOB article. The existing LOB article was negotiated in 1995 in the third Protocol. Canada then took the position that it did not want to rely on technical rules for protection against "treaty shopping." Instead it preferred to rely on general anti-abuse provisions. As a result, the LOB article applied only to the application of treaty benefits by the United States. No other U.S. treaty had a one-sided LOB article.

Canada has reversed its position on codifying "treaty shopping" rules in the new Protocol. Once ratified, the amended Treaty will become Canada's first comprehensive treaty that contains a bilateral LOB article. As a result, a U.S. resident seeking benefits from Canada under the Treaty will have to meet one of the tests under the LOB article.

Composition of LOB article

LOB provisions are included in virtually all tax treaties negotiated by the United States to prevent "treaty shopping," i.e., to prevent taxpayers in non-contracting states from gaining the benefits of treaties by forming entities in the treaty jurisdiction. The LOB article achieves this by imposing conditions that assess whether a taxpayer claiming benefits under a treaty has a sufficient connection with a contracting state to justify the benefits claimed.

The new LOB article provides a number of objective tests. The first, in paragraph 2, is an ownership test. A taxpayer that meets the requirements of this test is a "qualifying person" for purposes of the Treaty and is eligible for all of the benefits of its provisions. Paragraph 3 contains the "active trade or business" test. In essence, it assesses the strength of the economic ties between the taxpayer and a state. Under the active trade or business test, treaty benefits are limited to the income derived in connection with a particular business. A final test, the "derivative benefits" test, in paragraph 4, is based on the premise that treaty shopping is not present when the benefits available to an entity are similar to the benefits that could have been obtained by the owners of the entity. If this provision applies, treaty benefits may be extended to dividends, interest and royalties.

These tests remain virtually the same as those under Article XXIX A of the existing Treaty, except that they will apply to U.S. residents wishing to obtain tax benefits under the Treaty from Canada. The following section describes these tests in more detail, from the perspective of such a U.S. resident.

Qualifying person (paragraph 2)

To be eligible for all the tax benefits under the Treaty, a U.S. resident must be a "qualifying person," which includes:

- a) a natural person;
- b) the government of the United States, including a political subdivision, a local authority, or any agency

¹⁵ A detailed analysis of the LOB clauses is required and will yield different results based on the particular facts.

- or instrumentality of any such government, subdivision or authority;
- c) a company or trust whose principal class¹⁶ of shares or units (and any disproportionate class¹⁷ of shares or units) are primarily and regularly traded¹⁸ on one or more recognized stock exchanges;¹⁹
 - d) a subsidiary held by five or fewer companies or trusts meeting the requirements of (c) above, which own, directly or indirectly, 50% or more of the vote and the value of the shares and each disproportionate class of shares, in both cases excluding “debt substitute shares, provided that each company or trust in the chain of ownership is a qualifying person;”²⁰
 - e) either:
 - a company that meets the “base erosion test” described below and in which 50% or more of the vote or value of all shares and 50% of the vote and value of each disproportionate class of shares (in both cases excluding debt substitute shares) is not owned, directly or indirectly, by non-qualifying persons;²¹ or
 - a trust in which 50% or more is not beneficially owned, directly or indirectly, by non-qualifying persons and that meets the base erosion test;
 - f) an estate;²²
 - g) an entity that is exempt from income tax as a result of its not-for profit status, if more than half of its beneficiaries, members or participants are qualifying persons;
 - h) certain tax-exempt trusts, companies, or arrangements established exclusively for the purpose of providing pension, retirement, or employee benefits primarily to individuals who are, or within five years have been, qualifying persons, or feeder (funding) organizations for such entities;
 - i) a trust, company, organization or other arrangement provided the beneficiaries are described in (g) or (h) above.

16. “Principal class of shares” is defined in subparagraph 5(e) to be the ordinary or common shares of a company, if that class represents the majority of the vote and value. If no single class of shares has this characteristic, the principal class of shares are those classes in the aggregate that do.

17. “Disproportionate class of shares” is defined in subparagraph 5(c) and means a class of shares of a company resident in one state that entitles the holder to a disproportionately higher participation in the earnings generated in the other state – essentially, tracking shares.

18. The Treaty does not define the term “primarily and regularly traded.” However, the U.S. Model Treaty uses the terms “regularly” and “primarily.” The U.S. Model Technical Explanation indicates that in the case of the United States, “regularly” is understood to have the meaning that it has under Treas. Reg. section 1.884-5(d)(4)(i)(B), relating to the Branch provisions of the Code. Under these regulations, a class of shares is considered to be “regularly traded” if two requirements are met:

- trades in the class of shares are made in more than *de minimis* quantities on at least 60 days during the taxable year; and
- the aggregate number of shares in the class traded during the year is at least 10% of the average number of shares outstanding during the year.

The U.S. Model Technical Explanation also indicates that in the case of the United States, “primarily” is understood to have the meaning it has under Treas. Reg. section 1.884-5(d)(3). Accordingly, stock of a corporation is “primarily traded” if the number of shares in the company’s principal class of shares that are traded during the taxable year on all recognized stock exchanges in the Contracting State exceeds the number of shares in the company’s principal class of shares that are traded during the year on established securities markets any other single foreign country.

19. The term “recognized stock exchanges” is defined in subparagraph 5(f), and means the NASDAQ, any exchange registered as a national securities exchange with the Securities and Exchange Commission, and Canadian stock exchanges that are “prescribed stock exchanges” or “designated stock exchanges” under the *Income Tax Act*. This includes the exchanges of Montreal, Toronto and tiers 1 and 2 of the Canadian Venture Exchange, but does not include other exchanges, such as the Alternative Investments Market (AIM) or the London Exchange. Additional exchanges may be added by exchange of notes or agreement between competent authorities.

20. “Debt substitute shares” are defined in subparagraph 5(a) as shares described in paragraph (e) of the definition of “term preferred shares” in subsection 248(1) of the *Income Tax Act*, and are essentially shares issued by a company in financial distress. Competent authority agreements may extend the debt substitute shares exemption to other types of shares.

The base erosion test

The “base erosion” test must be met before treaty benefits will be extended to U.S. private corporations that would otherwise be a qualifying person based on the tests described in subparagraph 2(e) above. The base erosion test is intended to prevent the stripping of earnings out of the resident corporation to non-qualifying persons; which otherwise would permit a resident of a third country to benefit, indirectly, from the provisions of the Treaty with no reciprocal benefit to Canada or the United States.

The base erosion test requires that deductible payments made, either directly or indirectly, to persons who are non-qualifying persons must be less than 50% of the “gross income” of the resident corporation seeking treaty benefits. The term “gross income” is not defined in the Protocol; however, for purposes of U.S. domestic law, the term generally means gross receipts less cost of goods sold. It is not clear if further guidance from a Canadian perspective related to this term will be provided. The calculation is generally based on the preceding fiscal period of the entity except when the entity is newly formed, in which case the calculation is based on the current fiscal period.

21. The vote and value test applies to the shares in the aggregate rather than to each class. That requirement and the statement of the test in the negative, as highlighted above, are different from provisions in other U.S. treaties.

22. The Treaty treats an estate as a qualifying person regardless of the residency of the beneficiaries. Thus, a U.S. resident estate that holds shares of a Canadian company would be a qualifying person even if the sole beneficiary is a Hong Kong resident. Similarly, a Canadian resident estate that holds shares of a U.S. company would be a qualifying person even if the sole beneficiary is a Hong Kong resident.

Active trade or business (paragraph 3)

A non-qualifying person that is a resident of the United States may still be entitled to treaty benefits in respect of income derived from Canada if that person, or a related person, is engaged in the active conduct of a trade or business in the United States and the income derived from Canada is in connection with or incidental to that trade or business, but only if that trade or business is substantial in relation to the activity carried out in Canada. The treaty benefit is also available to any such income derived directly or indirectly through one or more other persons that are residents in Canada. A person will not, however, be able to satisfy the active business test if it solely carries on the business of making or managing investments, unless those activities are carried on with customers in the ordinary course of business by a bank, an insurance company, a registered securities dealer, or a deposit-taking financial institution.

The Technical Explanation to the 1995 Protocol, when addressing whether a Canadian resident satisfied the active trade or business test, indicated that:

Income is considered derived "in connection" with an active trade or business in the United States if, for example, the income generating activity in the United States is "upstream," "downstream," or parallel to that concluded in Canada. Thus, if the U.S. activity consisted of selling the output of a Canadian manufacturer or providing inputs to the manufacturing process, or of manufacturing or selling in the United States the same sort of products that were being sold by the Canadian trade or business in Canada, the income generated by that activity would be treated as earned in connection with the Canadian trade or business. Income is considered "incidental" to the Canadian trade or business if, for example, it arises from the short term investment of working capital of the Canadian resident in U.S. Securities.

A resident of the United States that is not a qualifying person may earn several different types of income from Canada. In this case, the active trade or business test must be applied to each type of income, whereas a company that is a qualifying person would be entitled to treaty benefits on all sources of income.

The 1995 Technical Explanation also indicates that:

To be considered substantial, it is not necessary that the Canadian trade or business be as large as the U.S. income-generating activity. The Canadian trade or business cannot, however, in terms of income, assets, or other similar measures, represent only a very small percentage of the size of the U.S. activity.

The assumption underlying this test is that taxpayers are unlikely to incur the expense of establishing a substantial trade or business in one of the contracting states primarily to avail themselves of the benefits of the Treaty. If the conditions of this test are fulfilled, it is presumed that the investor has a valid business purpose for becoming a resident of one of the contracting states.

Derivative benefits (paragraph 4)

A U.S. resident that is a company may be able to obtain limited treaty relief on dividends, interest and royalties received from Canada under the derivative benefits test. Unlike the two preceding tests, which assess the degree of connection that a person claiming treaty benefits has with a contracting state, the derivative benefits provision tests whether treaty shopping is present. The premise of this provision is that there is no treaty shopping motivation if the owners of a U.S. company could receive equally favourable treaty benefits from Canada directly. To achieve its objective, paragraph 4 looks to the ownership of the U.S. company and imposes a series of tests that are designed to ensure that no more than 10% of treaty-protected income leaks out to residents of third states that would not otherwise qualify for equally favourable treaty benefits.

More specifically, shares (other than debt substitute shares) representing more than 90% of the aggregate vote and value of the U.S. company, and at least 50% of the vote and value of any disproportionate shares, must be owned, directly or indirectly, either by qualifying persons, or other persons who satisfy the following three tests:

- a) First, the person must be a resident of a third country with which Canada has a comprehensive tax treaty and be entitled to *all* of the benefits under that treaty (clause 4(a)(i)).
- b) Second, the person would meet the requirements of the qualifying person test or the active business test on the assumption the person were resident in the United States, and, for the purposes of the active business test, the business were carried on in the United States (clause 4(a)(ii)).
- c) Third, the rate of Canadian withholding tax on the item of income for which benefits are sought must be at least as low under the treaty between Canada and the person's residence country as under the Treaty (clause 4(a)(iii)).

The Protocol provides no guidance on how indirect ownership is to be determined for the purpose of applying

these tests (or for those in subparagraphs 2(d) and (e), referred to above). It is also unclear how far up the chain of ownership it is necessary to go.

The ownership requirement under these rules does not refer to “ultimate” ownership by a small number of shareholders, as in some recent U.S. treaties. For example, Article XXIV(4)(a) of the Luxembourg-United States Treaty has a requirement under the derivatives benefits provision that a Luxembourg company be ultimately owned by seven or fewer residents of a state that is either an EU member or a party to NAFTA, if it is to qualify for the derivative benefits provision. The ultimate ownership rules have generally been interpreted as requiring that the ownership at the top individual level be tested.

Instead, the derivative benefits provision in the Treaty has a “directly or indirectly” ownership requirement, which is drafted as an affirmative test. It can be argued that it is sufficient to look up the chain of ownership until one finds a group of indirect shareholders that meet the requirements of subparagraph 4(a).²³

In addition to the above tests, the U.S. company must meet the base erosion test, described above (subparagraph 4(b)).

Competent authority relief

A U.S. person that is not able to qualify for treaty benefits under any of the preceding tests may apply to the Canadian competent authority for a determination that treaty benefits should be allowed. That determination is to be based either on a finding by the competent authority that the creation and existence of the U.S. person did not have as a principal purpose the obtaining of treaty benefits, or that it would not be “appropriate,” having regard to the purpose of the LOB article, to deny treaty benefits to that person.

Illustrative examples

Example 1: Lending through the United States

One may wonder why Canada sees the need for an LOB provision, especially since it was not considered necessary when the LOB was introduced in 1995. One

possibility is that residents of third countries may attempt to take advantage of the reduced treaty rate on interest.

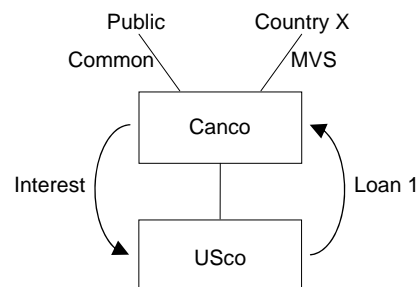
To illustrate, assume XCo owns 100% of Canco. XCo is resident in Country X that has a treaty with Canada. However, the withholding tax on interest under this treaty is higher than the rate under the Protocol to the Treaty. To minimize this withholding tax cost, XCo could capitalize a USco with equity used to lend to Canco. Assuming that corporate income tax rates in Country X, Canada and the United States are comparable, and the fact that withholding tax on dividends paid from USco could be as low as 5% or 0% under certain U.S. tax treaties, the cost of going through the U.S. may not be significant, compared to the saving on Canadian withholding tax.

Example 2: Canadian public company

This example illustrates how the LOB rules could apply to a U.S. subsidiary of a Canadian public company (Canco) with multiple voting shares (MVS).

Assume that Canco’s common shares are listed on a recognized stock exchange and are widely held. The MVS are not listed and are held by an individual resident in Country X. The MVS represent 55% of the vote of Canco and 10% of its value. Further, Canco has an interest bearing debt (“Loan 1”) owing to its subsidiary, USco. Loan 1 is funded with excess cash not required in USco’s active business (see Figure 7).

Figure 7



Do payments of interest by Canco to USco qualify for the reduced rate of withholding, as provided by Article XI of the Treaty?

The first step in answering this question would be to determine whether USco is a qualifying person. Because USco is wholly-owned by Canco, the only tests that could apply are those in subparagraphs 2(d) and (e), which require that Canco be a qualifying person. Although Canco is a public company, it cannot meet the listing

23. This contrasts with the negatively worded directly or indirectly test in subparagraph 2(e), which implies that the entire chain up to the topmost level, must be investigated for the presence of indirect non-qualifying shareholders.

requirements of subparagraph 2(c), because the MVS are not listed. Similarly, Canco cannot meet the requirements of subparagraphs 2(d) or 2(e). Accordingly, USco would not be considered a qualifying person.

The next step would be to consider the active trade or business test. To meet the active trade or business test, interest earned by USco on Loan 1 must meet two tests:

- the interest must be considered derived by USco “in connection with or incidental to” its business in the United States; and
- USco’s active business in the United States must be considered “substantial” in relation to the business carried on in Canada by Canco. A review of USco’s business activity and the connection between the interest income earned and that business activity would be necessary to determine if the interest paid by Canco to USco would qualify for reduced withholding under the active business test.

If USco fails the active business test, the interest paid by Canco may still qualify for the treaty rate if the conditions of the derivative benefits test in paragraph 4 are met. Clause 4(a)(i) requires, in part, that more than 90% of the total vote and value of all the shares of USco be owned, directly or indirectly, by qualifying persons or other persons, each of whom is resident in a country that has a treaty with Canada and who is entitled to all benefits under that treaty (the “90% Shareholder Group”).

It is not clear whether Canco is considered to be the 90% Shareholder Group, as it directly owns all of the shares of USco. If it is, USco would fail the test, because Canco is not a qualifying person. Alternatively, one could argue that looking through Canco to Canco’s shareholders would be appropriate. In this case, USco may meet the test, depending on where the members of the 90% Shareholder Group are resident and the terms of the treaty between the country of residence and Canada. In any case, it may not be practical or even possible for Canco to determine whether each member of the 90% Shareholder Group would be entitled to all benefits under the relevant treaty with Canada.

Example 3: Takeover of Canadian company

Assume that Canco, a Canadian public company, whose shares are traded on a recognized stock exchange, owns 100% of the shares of USco, a U.S. subsidiary. USco, in this case, would be a qualifying person under subparagraph 2(d). Now consider whether USco would still qualify for treaty benefits if Canco were to be acquired by USPubco, a U.S. public company, or by UKco, a

foreign company resident in a country that has a treaty with Canada, for example, the United Kingdom.

Situation 1: Acquired by USPubco

If acquired by USPubco, USco would continue to qualify for treaty benefits under subparagraph 2(d), as both Canco and USPubco are considered qualifying persons.

Situation 2: Acquired by UKco

If acquired by UKco, Canco is not a qualifying person because it is owned by UKco, which is not a qualifying person. Because Canco is not a qualifying person, USco will not be a qualifying person under subparagraph 2(d). It could, however, be a qualifying person if the ownership and base erosion tests in subparagraph 2(e) were met. The ownership test in subparagraph 2(e) requires, in part, that 50% or more of the vote and value of the shares of USco *not* be owned, directly or indirectly, by persons other than qualifying persons. This test would not be met in this example, because both Canco and UKco are not qualifying persons.

USco may qualify for limited benefits under either the provisions dealing with active trade or business or derivative benefits. The derivative benefits provision would not be available to USco, if instead of UKco, Canco was acquired by a company resident in a country that does not have a treaty with Canada.

Example 4: Takeover of U.S. company by a Canadian company

Consider a situation in which Canco, a Canadian public company, acquires the shares of BermudaCo, a Bermuda company, which, in turn, owns USco, a U.S. company. Canco’s shares are listed and regularly traded on the Toronto Stock Exchange, making Canco a qualifying person.

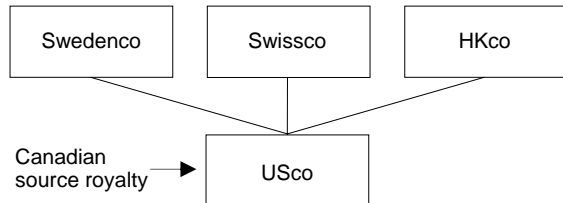
Although Canco is a qualifying person, BermudaCo is not. As a result, USco would not be a qualifying person because subparagraph 2(d) requires that each company in the ownership chain above USco be a qualifying person. However, USco may qualify for limited benefits under the Treaty if it can satisfy the active trade or business test or the derivative benefits test.

Example 5: Shares Owned Directly or Indirectly

This example illustrates complications that arise in applying the direct or indirect ownership test in the derivative benefits clause.

Assume that USco has one class of shares issued and outstanding that are held by three unrelated private companies: Swedenco and Swissco, each owning 40% of USco, and HKco which owns 20%. Swedenco, Swissco and HKco are resident in Sweden, Switzerland and Hong Kong, respectively, and each is privately held by individuals resident in the respective country (see Figure 8).

Figure 8

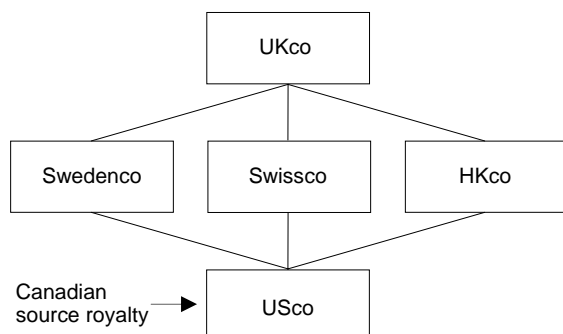


A Canadian person, unrelated to USco and its three shareholders, pays a royalty to USco. Absent the LOB, the royalty would be subject to a 10% withholding tax under the Treaty.

In this example, USco would not be a qualifying person. If we assume that the active trade or business test cannot be met, the only provision remaining to provide treaty relief is the derivatives benefits test in paragraph 4. That provision requires there to be a 90% Shareholder Group (see example 2) that meets the three tests in subparagraph 4(a). There is no such group, in this case, because the shares in USco held by HKco, representing 20% of USco's share capital, cannot meet the requirements of clause 4(a)(i) because Hong Kong does not have a treaty with Canada.

If, instead of the above ownership structure, Swedenco, Swissco and HKco were owned by UKco (see Figure 9), a company resident in the U.K., and the derivative benefits tests were applied on a look-through basis to the UKco level, depending on the facts USco could meet the 90% test in clause 4(a)(i).

Figure 9



Complications will arise in structures where there are multiple classes of shares with different features, including entitlement to vote and value. For instance, in example 2, the MVS entitle its holder to 55% of the vote and 10% of the value of Canco. Would this mean that the MVS holder is considered to own, indirectly, shares in the USco having 55% of the vote and 10% of the value, 100% of the vote (because the MVS holder controls) and 10% of the value, or only 10% of vote and value?

General anti-abuse provision

Although Canada has followed the U.S. approach in adopting a codified LOB provision, it is interesting to note that a general anti-abuse rule remains for both the United States and Canada in paragraph 7. This provision states that:

“It is understood that this article shall not be construed as restricting in any manner the right of Canada or the United States to deny benefits under this Treaty where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of this Treaty.”

The Technical Explanation to the 1995 Protocol provided the following background:

“Paragraph 7 was added at Canada’s request to confirm that the specific provisions of Article XXIX A and the fact that these provisions apply only for the purposes of the application of the Convention by the United States should not be construed so as to limit the right of each Contracting State to invoke applicable anti-abuse rules. Thus, for example, Canada remains free to apply such rules to counter abusive arrangements involving “treaty shopping” through the United States, and the United States remains free to apply its substance-over-form and anti-conduit rules, for example, in relation to Canadian residents. This principle is recognized by the Organization for Economic Cooperation and Development in the Commentaries to its Model Tax Convention on Income and on Capital, and the United States and Canada agree that it is inherent in the Convention. The agreement to state this principle explicitly in the Protocol is not intended to suggest that the principle is not also inherent in other tax conventions, including the current Convention with Canada.”

Notwithstanding these comments, we expect that it will be difficult for the CRA to successfully apply the GAAR to perceived treaty shopping abuse if the detailed tests in paragraphs 2 through 5 are met.

However, paragraph 7 may apply to other forms of possible treaty abuse that do not involve treaty shopping. An example might be structuring that has as its main

focus the characterization of a payment or receipt as something that qualifies for a preferential rate of tax, such as structuring to repatriate an amount as an exempt capital gain rather than in the form of a dividend. Possibly, paragraph 7 can be interpreted as simply affirming that abusive tax treaty planning is not limited to treaty shopping and that each jurisdiction is free to deny the benefits of the Convention that arise from other forms of abuse.

Coming into force

It appears the LOB will take effect on different dates depending on the nature of the income taxes involved. For taxes withheld at source, the LOB will apply for amounts paid or credited on or after the first day of the second month that begins after the date on which the Protocol enters into force (e.g., to amounts paid or credited on or after March 1, 2008, if the Protocol is ratified in both countries by the end of 2007). For other taxes, for example taxes in respect of capital gains, if ratification occurs in 2007, the LOB will be effective for taxable years beginning in 2008 or later. Otherwise, it will be effective for taxable years beginning after the calendar year in which the Protocol enters into force.

Implications for Canadian taxpayers

One thing that is clear is that in the future it will be far more difficult for Canadian taxpayers doing business with U.S. persons to know if those persons are eligible for benefits under the Treaty. Except in the case of U.S. public companies, it will often not be possible or, in any event, practical to assemble the information needed to apply the tests in the LOB. Further, as the examples above show, the rules appear to apply in some unexpected situations.

Under the *Income Tax Act*, it is the payer's responsibility to withhold and remit tax at the appropriate rate and the payer is liable to the Crown for any deficiency. Currently, the procedures that a payer needs to undertake to avoid liability are straightforward. According to Information Circular 76-12R5, a payer can usually accept the name and address of the payee as being that of the beneficial owner unless there is reasonable cause to suspect otherwise. In doubtful cases, the payer should obtain a certificate from the payee, but, in our experience, this is rarely done.

With the addition of the LOB clause, taxpayers will have to rely on a more extensive and formal certification process,

perhaps along the lines of the U.S. Form W-8Ben (Ownership, Exemption, or Reduced Rate Certificate). Whatever approach is taken, taxpayers need to know what they must do to avoid liability for underwithholding. Until the CRA establishes guidelines and procedures, taxpayers will be in an awkward position. On the one hand, they will be pressured by their business partners to apply the lower treaty rate. On the other hand, without extensive enquiries concerning the ownership, business activities and deductible expenses of a payee, they cannot know whether the payee is eligible for treaty benefits or not.

These issues will be particularly pressing for private companies because ownership structures are often complex and opaque. In addition, private enterprises are subject to a host of uncontrollable factors that are unique to them. For example, the emigration of a single individual may affect the qualifying person status of an entire group of companies.

Introduction of the LOB provision may affect existing contractual relationships. Taxpayers should review the withholding tax clauses of all relevant agreements. Those with gross-up clauses may result in substantial financial costs to Canadian taxpayers, should the U.S. party to the agreement cease to qualify for treaty benefits under the LOB article.

Final observations

The introduction of a comprehensive bilateral LOB provision into a Canadian tax treaty is a significant change in policy for Canada. In applying the LOB's detailed and technical tests, the CRA and Canadian taxpayers will face significant learning curves. The United States has extensive experience with LOB provisions, of course, including those in the current Treaty, and guidance concerning the U.S. approach is available to taxpayers from many sources. The extent to which that guidance will influence the CRA is unclear.

It remains to be seen whether the LOB article in the Treaty will simply be an aberration from Canada's typical tax treaties, or whether the signing of the Protocol is an indication of what taxpayers can expect in future treaties.

Accounting Implications

Although the changes included in the Protocol will not be considered substantively enacted for Canadian GAAP purposes or enacted for U.S. GAAP purposes until the

Protocol is ratified, companies should begin to assess the effect of the Protocol on future income tax balances. For example, the elimination of treaty benefits on dividends from certain hybrid entities should be taken into account in determining tax accruals in respect of unremitted earnings of U.S. subsidiaries. If unremitted earnings are not expected to be repatriated until after paragraph 7 of Article IV takes effect (January 1, 2010, at the earliest), the full U.S. domestic withholding tax rate of 30% would apply to the earnings of the foreign subsidiary, unless some other tax planning is undertaken.

In addition, companies should also consider the possible implications of the LOB article to their tax accruals. In certain cases, the introduction of the LOB provisions has the potential to give rise to significant unrecorded withholding tax liabilities (including failure to withhold penalties for the payor). At a minimum, the required controls should be put in place to ensure the required due diligence is undertaken (and documented) to support eligibility for treaty benefits.

Transfer Pricing

Attributing Profits to a Permanent Establishment—Treaty Article VII

Article VII (Business Profits) deals with the taxation of the business profits of a resident of one contracting state in the other contracting state, and limits those profits to the extent that the resident carries on business through a permanent establishment (PE). Paragraph 2 of Article VII of the existing Treaty states that the profits to be attributable to the PE will be “the business profits which it might be expected to make if it were distinct and separate person engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the resident ...”.

This paragraph has created much controversy, given numerous approaches to establishing the business profits associated with this fictional “separate entity.” The OECD issued its final report on the Attribution of Profits to a Permanent Establishment in December of 2006, recommending that the “functionally separate entity approach” should be adopted rather than the “relevant business activity approach.” The functionally separate entity” approach would allow the business profits of the PE to be established independent of whether the enterprise as a whole made a loss or a profit. The “relevant business activity approach,” which was rejected, limits the profits or losses of the PE to an allocation of the

profit or loss of the relevant business activity throughout the enterprise. The OECD concluded that the functionally separate entity approach mirrors the type of analysis that would be undertaken if the PE were a legally distinct and separate enterprise.

Annex B to the Convention states that the “business profits to be attributed to a permanent establishment shall include only the profits derived from the assets used, risks assumed, and activities performed by the permanent establishment. The principles of the OECD Transfer Pricing Guidelines shall apply for the purposes of determining the profits attributable to a permanent establishment, taking into account the different economic and legal circumstances of a single entity.” Therefore, by reference, the treaty partners are adopting the transfer pricing methods described in the OECD Transfer Pricing Guidelines, and the profit attributable to a PE will be determined under the same arm’s length principle that would be used between legally distinct enterprises.

Further commentary is in Annex B with respect to financial institutions and the attribution of capital, states that equity is to be allocated based on the risk-weighted assets attributable to them. No commentary was made to assist with the determination of capital outside of the financial services industry. With respect to insurance companies, Annex B states that in addition to allocating premiums earned to a PE, investment income should be allocated based on the reserves and surpluses that support the risks assumed by the PE. These comments are consistent with recent OECD reports in respect of these industries.

This clarification is good news for taxpayers, given the historic lack of certainty on how to establish business profits attributable to a PE, and whether “notional costs” or “internal dealings” could be considered. The functionally separate entity approach should allow the concept of notional costs and internal dealings when they are necessary to achieve an arm’s length result. This is a welcome endorsement of the current OECD position and should give taxpayers some peace of mind.

Arbitration—Treaty Article XXVI

With the signing of the Protocols, the two governments also exchanged Diplomatic Notes that paved the way for binding arbitration in mutual agreement procedure (MAP) cases. Arbitration will become effective with the coming into force of the Protocol after ratification. Briefly, it is the process referred to as “baseball” arbitration where a

3-member arbitration board selects one of the proposed resolutions provided by the competent authorities.

Qualifying cases

When the competent authorities have been unable to reach complete agreement on a case through the MAP process, the case can be resolved through arbitration proceedings (the proceedings) if:

- tax returns have been filed with at least one of the countries with respect to the taxable years at issue;
- the case involves the application of one or more articles in the Treaty that the competent authorities have agreed shall be the subject of arbitration;
- the competent authorities have agreed that the case is suitable for the Proceedings; and
- the concerned persons (the taxpayers) and their representatives have agreed in writing not to disclose any information received from either competent authority or the arbitration board during the Proceeding, other than the determination of the board.

Cases eligible for arbitration will include all MAP cases on hand at the time the Protocol comes into force. The competent authorities may agree that a case is not suitable for arbitration, but only before commencement of the Proceedings.

Commencement of arbitration proceedings

The Proceedings must begin on the later of:

- two years after the competent authorities have been provided with the information necessary to undertake substantive consideration of the MAP case (unless the competent authorities had previously agreed to a different date); and
- the filing of a notarized statement by the taxpayers and their representatives with both competent authorities agreeing not to disclose any information received during the Proceeding, other than the determination of the board.

It seems that the taxpayers, through the issuance of the non-disclosure letter, are the only parties that can initiate the Proceedings. For MAP cases on hand when the Protocol comes into force, it appears the two-year period commences on the date.

In Canada, information referred to in the first point is that which would be provided to the CRA in accordance with the current version of *Information Circular 71-17 Guidance*

on Competent Authority Assistance Under Canada's Tax Conventions. In the United States, the information is that which would be required to be submitted to the competent authority pursuant to *Revenue Procedure 2006-54, section 4.05* (or any applicable analogous provisions) and, for cases initially submitted as a request for an Advance Pricing Agreement (APA), the information required to be submitted to the Internal Revenue Service under *Revenue Procedure 2006-9, section 4* (or any applicable analogous provisions). In other words, filing a request for competent authority assistance in the form required by each government should suffice.

The arbitration process

Each country will have 60 days from the date the Proceedings begin to provide a written communication to the other country appointing a board member. Within 60 days from when the second written communication is sent, the two appointed board members are to appoint a third member, who will serve as the chair of the board. If either country fails to appoint a board member or the appointed board members fail to agree upon a third member, one country will ask the Secretariat at the Centre for Tax Policy and Administration of the Organisation for Economic Cooperation and Development to appoint the remaining member(s) to the board by written notice to both countries within 60 days. The chair of the arbitration board will be selected from lists of individuals provided by each competent authority.

Each country must submit, within 60 days of the appointment of the chair of the arbitration board, a proposed resolution to the case and a supporting position paper to the board. Once the board has received both submissions, each country will be provided with a copy of the other country's submission. If only one submission is received within the allotted time, the resolution contained in that submission will be deemed to be the determination of the board and the Proceedings will end.

Each country will have the opportunity to submit a reply submission to the board within 120 days of the appointment of its chair, to address any points raised in the submission of the other country. Additional information may be submitted only by a country at the request of the board. If the board does make a request, the other country will be provided with a copy of the request and subsequent response. All communications in the Proceedings must be in writing between the competent authorities and the chair of the board.

Within six months of the appointment of the chair of the arbitration board a written determination will be provided to the competent authorities. The determination will be one of the proposed resolutions submitted by the countries. While the determination of the board is binding on the countries, it will not state a rationale or be considered as a precedent for future cases.

Within 30 days of receiving the determination of the board from the competent authority, each taxpayer must advise the competent authority whether it accepts the board's determination. Failure to advise the competent authority within the allotted time will result in the determination being considered not to have been accepted. If a determination is not accepted, the case cannot be the subject of another Proceeding.

The one situation for which no time-line is provided pertains to the competent authority providing each taxpayer with the determination of the board. Because the board's determination is binding on the competent authorities, there appears to be no reason it cannot be provided immediately. The entire arbitration process should take less than one year to complete.

All fees and expenses of the board members will be shared by the two countries.

Termination of the arbitration proceedings

The competent authorities may still attempt to resolve the MAP case even after the Proceedings have commenced. If mutual agreement is reached, the competent authorities may terminate the Proceedings. The Protocol is mute on the process in the situation when the taxpayers do not agree to the settlement reached by the competent authorities and whether the opportunity exists to reinstate the Proceedings. Correspondingly, the taxpayers may terminate the Proceedings at any time by withdrawing their MAP requests.

Going forward

The introduction of arbitration can be perceived as a positive step in respect of quicker resolution of MAP cases. While there is no way of knowing how much use will be made of the process, it will act as an incentive for both sides to reach a settlement within the two-year period before a case becomes eligible for arbitration. With the "baseball" arbitration format, it is anticipated that both competent authorities will now present more reasonable

resolutions at earlier stages during the MAP process, to avoid arbitration.

Now that a procedure has been established, the process for its implementation has to be decided. With the first case not technically eligible for arbitration until at least January 1, 2010, both sides will have time to agree on how the process will be implemented. On the Canadian side, the Director-General of the Legislative Policy Directorate has already been asked to lead this endeavour with the delegated competent authority in the U.S. The resulting process will probably be formalized through a Memorandum of Understanding between the two countries. Because the Protocol contains a provision that allows the competent authorities to modify or supplement the rules and procedures as presented, the actual process may vary from that presented here.

In 2005, a Memorandum of Understanding was signed that provided a process to resolve disputes on the "facts" of the case. This process has not yet been used. Will the competent authorities consider using it to avoid arbitration?

While the APA program falls under the umbrella of the Treaty, we have been advised by the Canadian competent authority that the arbitration process is not expected to include APAs. The hurdle appears to be the fact that one of the qualifiers for arbitration is that tax returns have been filed with at least one of the countries with respect to the taxable years at issue. Including the APA program would have benefits, but the CRA has recently confirmed that the APA program is viewed as a voluntary election, and may use this as another argument for its exclusion.

The introduction of binding arbitration should not deter taxpayers from continuing to use the APA program to obtain certainty in their transfer pricing. Certainty for subsequent years can not be assured through the arbitration process, because the determination of the board has no precedential value.

The Protocol contains no restrictions that would prevent a taxpayer from using the domestic appeal process in the event it does not accept the board's determination.

In summary, although the entire process has yet to be clarified, it is a welcome step in speeding up the MAP process, but uncertainty of transfer pricing for subsequent years will continue to exist for taxpayers.

Personal Tax

Independent Personal Services Deemed Permanent Establishment—Treaty Article V

Article XIV of the current Treaty will be removed and its provisions will be covered under Article VII. As discussed above, attendant with the removal of Article XIV on independent services, Article V on permanent establishment has been amended to deem that an enterprise of one country providing services in the other country is providing those services through a permanent establishment in that other country, if and only if:

- the services are performed in that country by an individual who is present for 183 days or more in any 12-month period; and during that period the enterprise derives more than 50% of its gross active business revenues from the individual's service in that country; or
- the services are provided in a period of 183 days or more in any 12-month period in a country with respect to the same or connected project for customers resident in that country or on behalf of a permanent establishment that the customer maintains in that country. A "connected project" is defined in the Diplomatic Notes to the Convention (Annex B) to mean projects that "constitute a coherent whole, commercially or geographically."

According to the Diplomatic Notes, the removal of Article XIV on independent personal services was, due to the fact that no practical distinction could be made between a "fixed base," as that term was used in Article XIV to provide taxing nexus, and a permanent establishment. By linking independent personal services to Article VII (Business Profits) and as a consequence of amending the permanent establishment provisions, there is now a more determinative and measurable basis for deeming independent personal services to be carried on through a permanent establishment and, as a result, the scope of each country's right to taxation has been broadened.

Because the period for measuring the 183 days is not tied to a specific year, it is a rolling 12-month period that can be broken only by a continuous 12-month period in which no services are provided.

The amendments will result in more enterprises that provide services in the other jurisdiction having a permanent establishment, which will create an obligation for tax in the other jurisdiction not only to the enterprise

but also to the employees or individuals providing the services. This obligation will also extend to payroll registration, withholding and reporting. It will require tax filing in both jurisdictions by the individuals affected and complexities will result due to differences in the reporting basis of each jurisdiction, for example when a U.S. Subchapter S Corporation renders services in Canada by its shareholder.

Canadian Residency Termination: Deemed Disposition—Treaty Article XIII

Under Canadian tax law, a taxpayer is deemed to have disposed of property at its fair market value immediately before ceasing tax residency in Canada. Some exceptions apply to property held by taxpayers who have not resided in Canada for five years or more before residency termination. Also excluded from the deemed disposition rules are real property in Canada, RRSP and RRIF funds, and pension or other deferred compensation rights or entitlements. To the extent the deemed disposition of property results in a capital gain, the taxpayer has the option of paying the tax or electing to defer the tax.

An election to defer the tax requires security lodged with the CRA for the tax on any gain in excess of \$100,000, with no security required on elections to defer the tax on gains of less than \$100,000. The tax becomes payable on actual disposition of the property. If the taxpayer is resident in the U.S. at the time of actual disposition of the property, the U.S. tax paid is eligible for credit (with no limitation on the carry-back period) against the Canadian tax on the deemed disposition. However double taxation can result from provincial tax limitations that may not allow a credit for U.S. taxes paid.

Paragraph 7 of Article XIII (Gains) of the Protocol permits an individual who has terminated Canadian residency after September 17, 2000, to elect that the deemed disposition occurs also for U.S. tax purposes. This creates a mark-to-market adjustment in the tax basis of assets for U.S. tax purposes and avoids the potential for double taxation, because it permits accrued gains in assets to the date of Canadian residency termination to be exempt from U.S. tax. This amendment likely will benefit only those terminating Canadian residency who are not U.S. citizens or U.S. green card holders and individuals who do not elect to be taxed in the U.S. on a full-year basis in the year of residency change ("U.S. taxpayers").

U.S. taxpayers will be taxed in the U.S. on the elections and may face potential double taxation due to U.S. federal

or state foreign tax credit limitations. By electing the deemed disposition, they may also be accelerating the recognition of a higher capital gain due to lower historical cost basis for U.S. tax purposes.

This amendment essentially broadens the ability for Canadian residents to elect the deemed disposition for U.S. purposes, which previously was available only to U.S. taxpayers. Canadian residents, who are not also U.S. taxpayers, will likely elect that the deemed disposition on their residency termination also occurs for U.S. tax purposes even when they have elected to defer Canadian tax, unless there is a decided tax advantage to filing as full-year residents in the year of their move. The amendment is effective for Canadian residency terminations after September 17, 2000, so case-by-case consideration should be given to whether to retroactively elect the deemed disposition for U.S. purposes under the Treaty and whether there is an overall tax advantage to making this election.

Taxable Canadian Property—Treaty Article XIII

Another notable change in Article XIII is contained in paragraph 5, which provides either country taxing rights on dispositions within 10 years of residency termination when an individual was resident in the country for at least 10 of any 20 consecutive years before the disposition. This right of taxation applied to property owned (or substituted property) at the time of residency termination and, in essence, protected Canada's right to taxation of gains on the disposition of taxable Canadian property, other than real property or business property, because both U.S. and Canadian domestic law and the Treaty still extend the right of either country to tax such property gains.

The amendment exempts U.S. taxpayers who were formerly Canadian residents from Canadian tax on dispositions of taxable Canadian property (other than real property) within 10 years of their residency termination, if the property was subject to the deemed disposition on residency termination. This is a substantive change, exempting from Canadian tax future appreciation realized after ceasing Canadian residency on taxable Canadian property including tax on Canadian private company shares, certain Canadian public company shares and interest in certain Canadian trusts. This amendment will align the U.S. and Canadian right to tax gains realized by residents of the other country only on real property,

including resource and business property located in one country.

Income from Employment—Treaty Article XV

The Protocol makes a significant change with respect to the 183-day rule for employment "exercised" in one country by a resident of the other country. In addition, other wording changes in new Article XV appear to further broaden the scope for taxation by a resident of one country for employment exercised in the other country.

183-day rule

Under the amendment to Article XV in the Protocol, an individual resident in one country will be subject to tax in a taxation year on employment income earned in the other country, if present in that country for periods in excess of 183 days in any twelve-month period commencing or ending in the taxation year concerned. The current Treaty permits taxation of employment income, in the country where the employment was exercised, but only if an individual was present in that country more than 183 days in the given taxation year. Therefore, the individual could have exempted employment income from tax in the other country if 183 days of employment services straddled two taxation years.

This change will broaden the scope for the taxation of employment income, because individuals previously could avoid taxation by limiting their days of presence to 183 or less in a given taxation year. Furthermore, it will require employers whose employees participate in cross-border business travel to more closely monitor employees' days present in the other jurisdiction to determine whether their employment activity will result in taxation by that other jurisdiction.

Economic employer

Under the Protocol, if an individual resident in one country provides employment services in the other country and is present in that other country for the requisite 183 days or less, his or her remuneration will not be subject to tax in the other country unless the remuneration is paid by or on behalf of a person who is resident in that country and is borne by a permanent establishment in that country. This replaces wording that exempted the remuneration from tax when the employee was present for 183 days or less and his or her remuneration was not borne by an employer who is a resident in the country where the

employment was exercised or by a permanent establishment or fixed base which the employer has in that country.

Under the current treaty wording, one could argue that if the economic and legal employer seconded an employee to an entity in the other jurisdiction and did not maintain an office, fixed base or other permanent establishment in the other jurisdiction, that the employee would not be subject to tax on employment exercised there, even if the remuneration was charged to the other entity and the employee was under the direction and control of management of that other entity. The new wording does not refer to “an employer” and as a result appears to broaden the scope for taxation, particularly if the amount of remuneration is cross-charged to the entity for which the services are provided. Except perhaps for certain stewardship functions, under general transfer pricing principles, employment services exercised for an entity in the other jurisdiction would require an allocation of related remuneration costs, which would result in the costs being “borne” by the entity and, as a consequence, taxation of the employee by the other jurisdiction.

A final note on the amendments to Article XV is that the \$10,000 remuneration exemption from taxation in the other jurisdiction continues. However, it is not linked to any time period as is currently the case. This appears to be an oversight in the drafting of the amendments to Article XV and we anticipate that a correction will link the \$10,000 exemption to any 12-month period commencing or ending in the particular year concerned.

Stock Options—Treaty Articles XV and XXIV

In the course of treaty negotiations, the negotiators developed and agreed upon a common understanding and interpretation of certain treaty provisions (Annex B to the Convention). Included in this interpretive document is a basis for the apportionment of taxing rights between the two countries when an employee is granted stock options as an employee in one country and before their exercise is employed in the other.

The new tax basis will avoid the problem of double taxation due to inconsistent sourcing of the option benefit by the respective countries. The apportionment is based on the ratio of the number of days in which the individual was employed at his/her principal place of employment in the particular jurisdiction to the number of days employed in the period between the date of grant and date of

exercise. This basis of apportionment was generally followed for Canadian tax purposes, but was inconsistent with the U.S. sourcing basis, which apportioned employment days over the period between the date of an option grant and the option vesting date.

In addition to these guidelines on stock option sourcing, the competent authorities of both jurisdictions may also agree to attribute income on a different basis if the terms of the option were such that the grant was essentially a transfer of the securities to the employee, either because the options were in-the-money or were not subject to a substantial vesting period. Presumably such income could be apportioned between the two jurisdictions if the grant were in respect of service by the employee carried on in both jurisdictions.

Pensions and Annuities—Treaty Article XVIII

The current Treaty deals with the taxation of distributions of pensions and annuities and the ability to defer taxation of income accrued in a foreign pension plan until distribution. The proposed changes to the Treaty generally will not affect the taxation of distributions of pensions and annuities.

The Protocol clarifies that a ROTH IRA is a pension and will qualify for deferral of income until distribution, with some exceptions.

The Protocol also adds new provisions that will permit deductible contributions to a qualifying retirement plan when the individual lives in one country and works in the other country or goes on a work assignment to the other country for a period that is less than five years.

Both the U.S. and Canada will permit an employee on a temporary work assignment to deduct, in the country in which they work, contributions made to a qualifying retirement plan in the other country. The employee must have participated in the plan before beginning the work assignment. The deductible contribution will be limited to the amount that would be deductible under the domestic laws of the country where the qualifying retirement plan is located (e.g., contribution limit for contributions to a Canadian registered pension plan (RPP) by an employee on a temporary assignment in the United States determined by Canadian RPP deduction limits).

Cross-border commuters will now be entitled to participate in qualifying retirement plans in the country where they

work. For Canadian purposes, the deductible contributions to a foreign plan will be limited by the Registered Retirement Savings Plan (RRSP) contribution limit for the year less any actual RRSP contributions made. Qualifying retirement plans include Canadian registered plans, U.S. qualifying plans and U.S. 401(k) plans. They do not include RRSPs to which there is no employer contribution.

Students—Treaty Article XX

Article XX of the Treaty exempts from tax any payments received by a student, apprentice, or business trainee in a country from sources outside that country if the individual was resident in other country immediately before taking up the education or training activity, provided that such payments are for the purpose of maintenance, education or training. This article has been amended to limit the exemption to one year for apprentices or business trainees.

U.S. Expatriation—Treaty Article XXIX

Paragraph 2 of Article XXIX (Miscellaneous Rules) permits the United States to tax U.S. source income for former citizens for 10 years following the relinquishment of their citizenship. It has been broadened to permit the U.S. to similarly tax former “long-term residents” for 10 years following the loss of that status. The term “long-term resident” is defined in the Diplomatic Notes, Annex B to the Convention, to mean an individual who is a lawful permanent resident (commonly referred to as a “green card holder”) of the United States in eight or more taxable years in the preceding fifteen taxable years, exclusive of years in which the individual was a treaty resident of Canada or of another country with which the U.S. has a treaty. These expatriation provisions are set out in the U.S. Internal Revenue Code and the Treaty simply reconfirms the U.S. right to tax its former citizens and long-term residents.

PricewaterhouseCoopers Contacts

Please contact any of the following individuals for more information on this topic.

International Tax			
Calgary	Murray Lee	403 509 7576	<i>murray.lee@ca.pwc.com</i>
	James Meadow	403 509 7353	<i>james.m.meadow@ca.pwc.com</i>
	Dale Meister	403 509 7584	<i>dale.s.meister@ca.pwc.com</i>
Vancouver	Michael Balaski	604 806 7073	<i>michael.e.balaski@ca.pwc.com</i>
	Paul Bush	604 806 7021	<i>paul.bush@ca.pwc.com</i>
	Bettina Charpentier	604 806 7026	<i>bettina.charpentier@ca.pwc.com</i>
	William Holms	604 806 7052	<i>william.holms@ca.pwc.com</i>
	Bruce McGregor	604 806 7079	<i>bruce.mcgregor@ca.pwc.com</i>
	Lincoln Schreiner	604 806 7713	<i>lincoln.schreiner@ca.pwc.com</i>
	Michael Shields	604 806 7802	<i>michael.shields@ca.pwc.com</i>
Montreal	Jay Black	514 205 5033	<i>jay.black@ca.pwc.com</i>
	Pierre Bourgeois	514 205 5139	<i>pierre.bourgeois@ca.pwc.com</i>
Toronto	Paul Barnicke	416 869 2369	<i>paul.l.barnicke@ca.pwc.com</i>
	Ken Buttenham	416 869 2600	<i>ken.butttenham@ca.pwc.com</i>
	Stephen Dunk	416 365 8239	<i>steve.dunk@ca.pwc.com</i>
	Melanie Huynh	416 869 2941	<i>melanie.huynh@ca.pwc.com</i>
	Eric Lockwood	416 365 8180	<i>eric.lockwood@ca.pwc.com</i>
	Mike Maikawa	416 365 2719	<i>mike.maikawa@ca.pwc.com</i>
	Andy McAskile	416 869 8725	<i>andrew.mcaskile@ca.pwc.com</i>
	Nick Pantaleo	416 365 2701	<i>nick.pantaleo@ca.pwc.com</i>
	Gregory Papinko	416 869 8702	<i>gregory.j.papinko@ca.pwc.com</i>
	Phyllis Roy	416 815 5034	<i>phyllis.r.roy@ca.pwc.com</i>
	Lloyd Sparling	416 365 8185	<i>lloyd.c.sparling@ca.pwc.com</i>
	Toronto North	Arlene Cohen	416 228 1012
David Grosman		416 218 1474	<i>david.grosman@ca.pwc.com</i>
Mississauga	Dan Fontaine	905 949 7313	<i>dan.g.fontaine@ca.pwc.com</i>
Transfer Pricing			
Toronto	Andy McCrodan	416 869 8726	<i>andrew.f.mccrodan@ca.pwc.com</i>
	Martin Skretkowicz	416 815 5027	<i>martin.p.skretkowicz@ca.pwc.com</i>
Personal Tax			
Calgary	Dave Peters	403 509 7481	<i>dave.peters@ca.pwc.com</i>
Vancouver	Diane Akelaitis	604 806 7011	<i>diane.akelaitis@ca.pwc.com</i>
Montreal	Jean Milot	514 205 5186	<i>jean.milot@ca.pwc.com</i>
Toronto	Jerry Alberton	416 365 2746	<i>jerry.alberton@ca.pwc.com</i>
Windsor	Loris Macor	519 985 8913	<i>loris.macor@ca.pwc.com</i>

Other PricewaterhouseCoopers Contacts across Canada

Alberta			
Calgary	Dale Meister	403 509 7584	<i>dale.s.meister@ca.pwc.com</i>
Edmonton	Dan Woodruff	780 441 6810	<i>daniel.a.woodruff@ca.pwc.com</i>
British Columbia			
Vancouver	Brad Sakich	604 806 7730	<i>brad.a.sakich@ca.pwc.com</i>
Manitoba			
Winnipeg	David Loewen	204 926 2428	<i>dave.loewen@ca.pwc.com</i>
Maritimes			
Saint John/Halifax	Dean Landry	506 653 9427	<i>dean.landry@ca.pwc.com</i>
Newfoundland and Labrador			
St. John's	Allison Saunders	709 722 3883	<i>allison.j.saunders@ca.pwc.com</i>
Quebec			
Montreal	Pierre Lessard	514 205 5034	<i>pierre.lessard@ca.pwc.com</i>
Quebec City	Claude Laforce	418 691 2439	<i>claudio.laforce@ca.pwc.com</i>
Ontario			
Hamilton	Jason Safar	905 972 4118	<i>jason.safar@ca.pwc.com</i>
Kitchener/Waterloo	Mark Walters	519 570 5755	<i>mark.g.walters@ca.pwc.com</i>
London	Tom Mitchell	519 640 7916	<i>tom.r.mitchell@ca.pwc.com</i>
Mississauga	Betty Ann Jarrett	905 949 7314	<i>betty.ann.jarrett@ca.pwc.com</i>
Ottawa	Lois McCarron Mcguire	613 755 4345	<i>lois.a.mccarron-mcguire@ca.pwc.com</i>
Toronto	Brenda Humphreys	416 814 5765	<i>brenda.j.humphreys@ca.pwc.com</i>
Toronto North	Louis Provenzano	416 218 1563	<i>louis.j.provenzano@ca.pwc.com</i>
Windsor	Debbie Meloche	519 985 8910	<i>debbie.d.meloche@ca.pwc.com</i>
Saskatchewan			
Saskatoon	Frank Baldry	306 668 5910	<i>frank.m.baldry@ca.pwc.com</i>

© 2007 PricewaterhouseCoopers LLP. All rights reserved. "PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP, an Ontario limited liability partnership, or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity.

This publication is intended to inform readers of developments as of the date of publication, and is neither a definitive analysis of the law nor a substitute for professional advice. Readers should discuss with professional advisers how the information may apply to their specific situations.

This publication may be displayed or printed only if for personal non-commercial use and unchanged (with all copyright and other proprietary notices retained). Unauthorized reproduction is expressly prohibited.