

In Print

Navigating the New Bilateral Limitation-on-Benefits Rule

by Kara Ann Selby

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This *In Print* provides a general explanation of the limitation-on-benefits article, examines select practical problems in its application, highlights areas in which additional guidance is required and identifies possible issues and anomalies taxpayers may encounter in applying these new rules. As well, decision-making flowcharts illustrate the eligibility of persons claiming treaty benefits under the Canada-U.S. Tax Treaty.

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INTERNATIONAL TAX PLANNING

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NAVIGATING THE NEW BILATERAL LIMITATION-ON-BENEFITS RULE

*Kara Ann Selby***

In this paper, the author provides a general explanation of the limitation-on-benefits article, examines selected practical problems in its application, highlights areas in which additional guidance is required, identifies potential problems and anomalies that taxpayers may encounter in applying the new rules, and makes certain recommendations.

KEYWORDS: TREATY ■ TREATY SHOPPING ■ WITHHOLDING TAXES ■ CAPITAL GAINS ■ BENEFITS ■ RESIDENCE

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INTRODUCTION

The fifth protocol to the Canada-US tax treaty¹ replaces article XXIX A, the limitation-on-benefits (LOB) article that was negotiated in 1995 in the third protocol,² with a new LOB article.³ Previously, the LOB article was one-sided in the sense that it applied only to Canadian residents who sought treaty benefits from the United States. No other US treaty contained a one-sided LOB article.

The introduction of a comprehensive bilateral LOB article into a tax treaty represents a significant change in policy for Canada. Canada reversed its position in the protocol in lieu of relying on the less restrictive anti-treaty-shopping rules that were previously applicable under Canadian tax law. This change is likely the result of Canada's inability to prevent perceived treaty-shopping abuses through the application of the Canadian general anti-avoidance rule (GAAR).⁴ Now, US residents that seek treaty benefits from Canada must satisfy one of the tests established in the LOB article.

Examination of the protocol resulted in numerous questions from taxpayers, advisers, and academics about how the Canadian tax authorities will interpret the LOB article. Then, on July 10, 2008, the US Treasury Department released the technical explanation to the protocol,⁵ which was expected to provide guidance concerning

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- 1 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein referred to as "the Canada-US tax treaty" or "the treaty").
 - 2 1995 protocol enacted in Canada by SC 1995, c. 34.
 - 3 The protocol was signed on September 21, 2007. Canada ratified the protocol on December 14, 2007, when Bill S-2 (An Act To Amend the Canada-United States Tax Convention Act, 1984, SC 2007, c. 32) received royal assent. The US ratification process requires the US president to sign the protocol or an instrument of ratification. On September 23, 2008, the US Senate approved the protocol by unanimous consent. On December 15, 2008, the protocol entered into force. On this date, Canada and the United States notified each other in writing through diplomatic channels that their respective procedures had been satisfied.
 - 4 The Canada Revenue Agency (CRA) has attempted to apply GAAR to combat perceived treaty-shopping abuses without success. See *Canada v. MIL (Investments) SA*, 2007 FCA 236, and *Prévost Car Inc. v. The Queen*, 2008 TCC 231. The decision of the Tax Court in *Prévost Car* is being appealed to the Federal Court of Appeal.
 - 5 United States, Treasury Department, Technical Explanation of the Protocol Done at Chelsea on September 21, 2007, Amending the Income Tax Convention Between the United States of America and Canada (herein referred to as "the technical explanation").

these questions (and others) relating to the protocol's application. Although helpful in some areas, the technical explanation does not address all questions. Canada's minister of finance announced that Canada reviewed the US document and agrees that it "accurately reflects understandings reached in the course of negotiations with respect to the interpretation and application of the various provisions in the Protocol."⁶ These comments constitute the first Canadian official endorsement of a technical explanation prepared by the United States that indicates that both countries provided their views on the application of the protocol.

During the Canada Revenue Agency (CRA) round table at the 2008 annual conference of the Canadian Tax Foundation,⁷ the CRA confirmed its intention to interpret the LOB article in a manner consistent with its object and purpose (the prevention of treaty shopping). Where limited guidance is provided, the CRA indicated that consideration should also be given to the interpretive approach adopted by the United States, including the technical explanation to the US model convention.⁸

In addition to raising interpretation issues, the application of the bilateral LOB article also creates significant practical implications. Now, to be eligible for a reduced tax rate under the treaty, a Canadian taxpayer that pays an amount to a US resident to which withholding tax can apply must not only consider whether it is entitled to treaty benefits based on residence, but must also determine whether it meets the conditions of the LOB article.

The purpose of this paper is to provide a general explanation of the LOB article, examine selected practical problems in its application, highlight areas in which additional guidance is required, identify potential problems and anomalies that taxpayers may encounter in applying the new rules, and make certain recommendations for improving the current situation.

THE NEW BILATERAL ARTICLE XXIX A

Generally, to be entitled to the benefits of the treaty, a person must, among other things,

- be a resident of Canada or the United States within the meaning of the treaty, and
- satisfy the requirements of the LOB article.⁹

6 Canada, Department of Finance, "Canada Supports U.S. Technical Explanation of the Fifth Protocol to the Canada-United States Income Tax Convention," *Release* no. 2008-052, July 10, 2008.

7 "Canada Revenue Agency Round Table" in *Report of Proceedings of the Sixtieth Tax Conference*, 2008 Conference Report (Toronto: Canadian Tax Foundation) (forthcoming) (herein referred to as "the 2008 round table").

8 United States, Department of the Treasury, United States Model Income Tax Convention of November 15, 2006 (herein referred to as "the US model convention").

9 The taxpayer must also be the beneficial owner of the income for which the treaty benefits are sought.

The purpose of the LOB article is to prevent treaty shopping by imposing conditions that assess whether a taxpayer that claims benefits under the treaty has a sufficient connection with Canada or the United States to justify the benefits claimed. Thus, the LOB article limits the ability of third-country residents to engage in treaty shopping by establishing legal entities in either Canada or the United States to obtain the benefits of the treaty.

The article sets out a number of objective tests that are largely mechanical in nature. A resident of Canada or the United States that satisfies any of these tests is generally entitled to all of the benefits of the treaty, regardless of whether the resident was formed for the purpose of tax avoidance.¹⁰ The tests include:

- a qualifying person test,¹¹
- an active trade or business test,¹² and
- a derivative benefits test.¹³

The qualifying person test contains certain ownership tests and a base-erosion test. The active trade or business test determines the nature of a person's activity and its economic connection to this activity. The derivative benefits test provides limited treaty relief in respect of dividends, interest, and royalties, provided that the tax on these payments made by a resident of one contracting state to a resident of the other contracting state is "at least as low as" the tax that would have been payable had the payments been made to the owner of the resident of the recipient contracting state directly. For the most part, these tests remain virtually identical to those under the pre-existing treaty, except that they now also apply to US residents that seek treaty benefits from Canada.

A US or Canadian person that is unable to qualify for treaty benefits under any of the preceding tests may apply to the Canadian or US competent authorities under article XXIX A(6) for a determination that it nevertheless should be granted treaty benefits.

IMPLICATIONS FOR CANADIAN TAXPAYERS

For the first time, a Canadian resident that makes payments to a US resident now bears the responsibility for determining whether the recipient of the payments is a qualifying person or meets the other tests under the LOB article. This determination becomes important, for example, when a company is considering whether it is eligible for reduced tax rates on dividend payments, interest payments, and royalty

10 See New York City Bar, Committee on Taxation of Business Entities, "Report Offering Proposals Regarding the 'Derivative Benefits' Provision Found in the Limitation on Benefits Article of Certain U.S. Income Tax Treaties" (May 21, 2008), *BNA Daily Tax Report*, released on May 28, 2008.

11 Article XXIX A(2).

12 Article XXIX A(3).

13 Article XXIX A(4).

payments, or for an exemption from gains or business profits attributable to a permanent establishment.¹⁴

Except in the case of US public corporations, it will often be impossible or impractical to assemble the information that is required to apply the tests in the LOB article. Determining the ultimate beneficial ownership of the payee may be difficult, if not impossible, in certain situations. When it is not clear that the payee is a qualifying person or meets one of the other tests in the LOB article, the Canadian resident payer may have no choice but to withhold at a non-treaty rate. Further, the rules appear to apply in some unexpected situations, as demonstrated in the examples below.

The LOB article introduces an entirely new due diligence standard. Under the Income Tax Act,¹⁵ it is the Canadian taxpayer's responsibility to withhold and remit at the appropriate rate, and the Canadian taxpayer is liable to the Crown for any deficiency.¹⁶ With the comprehensive LOB article, Canadian taxpayers now must rely on a more extensive and formal certification process. In fact, the CRA has announced plans to introduce procedures and forms to clarify the inquiries that it expects the Canadian resident payer to make.¹⁷ However, until these guidelines and procedures are established, taxpayers that cannot verify a recipient's eligibility to claim treaty benefits are left in a difficult position.

Owing to the complexity of the LOB provisions, the appendix to this article contains decision-making flowcharts that focus on the eligibility of various persons that claim treaty benefits under the protocol.¹⁸ While the flowcharts provide a

14 The LOB article takes effect on different dates, depending on the nature of the income taxes involved. For taxes withheld at source, the LOB applies to amounts paid or credited on or after February 1, 2009 (the first day of the second month that begins after the protocol's entry into force). For other taxes, the LOB is effective for taxable years beginning after 2008 (the calendar year in which the protocol entered into force).

15 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act and regulations made under it.

16 Canada Revenue Agency, *Information Circular* 76-12R5, "Applicable Rate of Part XIII Tax on Amounts Paid or Credited to Persons in Countries with Which Canada Has a Tax Convention," at paragraph 4, states that a payer can accept the name and address of the payee as that of the beneficial owner unless there is reasonable cause to suspect that the payee is not the beneficial owner. In doubtful cases, the payer should obtain a certificate from the payee.

17 During the International Fiscal Association (Canadian branch) tax seminar, May 12, 2008 (herein referred to as "the 2008 IFA seminar") and the 2008 round table, supra note 7, CRA officials confirmed that the CRA was reviewing the procedures to be followed and the new forms that may be required to supplement the existing procedures. The United States requires US residents that make payments to non-residents to file the Internal Revenue Service form W-8BEN (certificate of foreign status of beneficial owner for United States tax withholding).

18 These flowcharts have been adapted from John Venuti, Ron Dabrowski, Douglas Poms, and Alexey Manasuev, "Eligibility for Treaty Benefits Under the France-U.S. Income Tax Treaty," Special Reports (2008) vol. 49, no. 6 *Tax Notes International* 523. Although much of the wording in the flowcharts has been retained, the interaction between figure 4 and the other flow charts in the appendix has been substantially changed in the interest of clarity and brevity. Similarly, some aspects of the flowcharts have been altered to clarify logical relationships.

comprehensive review of the LOB article, the factual circumstances surrounding each case must be carefully evaluated before determining whether the requirements under this article have been met.

QUALIFYING PERSON TESTS

Article XXIX A(2) provides that a resident of Canada or the United States that is a qualifying person is entitled to all benefits accorded by the treaty. A qualifying person includes

1. a natural person;
2. the government of the United States or Canada, including a political subdivision, a local authority, or any agency or instrumentality of any such government, subdivision, or authority;
3. a company or trust whose principal class of shares or units (and any disproportionate class of shares or units) is primarily and regularly traded on one or more recognized stock exchanges;
4. a company, if five or fewer persons each of which is a company or trust referred to in (3) above own directly or indirectly more than 50 percent of the aggregate vote and the value of the shares and more than 50 percent of the vote and value of each disproportionate class of shares (in neither case including debt substitute shares),¹⁹ provided that each company or trust in the chain of ownership is a qualifying person;
5. either
 - a. a company, 50 percent or more of the aggregate vote and value of whose shares and 50 percent 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;²⁰ or
 - b. a trust, 50 percent or more of the beneficial interest and 50 percent or more of each disproportionate interest is not beneficially owned, directly or indirectly, by non-qualifying persons; and
 - c. the company or trust meets the base-erosion test (described below);
6. an estate;²¹
7. a not-for-profit organization, if more than half of its beneficiaries, members, or participants are qualifying persons;

19 “Debt substitute shares” are defined in article XXIX A(5)(a) as shares described in paragraph (e) of the definition of “term preferred shares” in subsection 248(1) of the Act. Debt substitute shares are essentially shares issued by a company that is in financial distress. Competent authority agreements may extend the debt substitute shares exemption to other types of shares.

20 The vote and value test applies to the shares in aggregate rather than to each class of shares.

21 The treaty considers an estate to be a qualifying person regardless of the residence of the beneficiaries.

8. certain tax-exempt trusts, companies, organizations, or other arrangements that are 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; and
9. a trust, company, organization, or other arrangement, provided that the beneficiaries are described in (7) or (8) above.

ARTICLE XXIX A(2)(c): PUBLIC COMPANY EXEMPTION

To qualify for the public company exemption described in article XXIX A(2)(c), the following conditions must be met:

- the company must be resident in Canada or the United States,
- its principal class of shares or units must be traded on a recognized stock exchange,
- these shares or units must be primarily and regularly traded, and
- any disproportionate class of shares or units must also be primarily and regularly traded on a recognized stock exchange.

Article XXIX A(5)(e) defines “principal class of shares” to mean the ordinary or common shares of a company, if this class represents the majority of the vote and value of the company. If no single class of shares qualifies, the principal class of shares is any combination of shares that qualify.

Article XXIX A(5)(f) defines “recognized stock exchanges” to mean the NASDAQ, any exchange registered as a national securities exchange with the Securities and Exchange Commission, or any Canadian stock exchange that is one of the “prescribed stock exchanges” or “designated stock exchanges” under the Act.

The technical explanation states that subject to the adoption by Canada of other definitions, Canada accepts the US interpretation of the terms “primarily traded” and “regularly traded,” with modifications as circumstances require for the purposes of article XXIX A(2)(c). In the case of the United States, the technical explanation indicates that “primarily” has the meaning assigned to it under Treas. reg. section 1.884-5(d)(3).²² 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 all other established securities markets in any other single foreign country. The technical explanation also indicates that in the United States, “regularly” has the same meaning that it has under Treas. reg. section 1.884-5(d)(4)(i)(B), relating to the branch provisions of the IRC. Based on these regulations, a class of shares is considered to be regularly traded if two requirements are met:

22 Internal Revenue Code of 1986, as amended (herein referred to as “the IRC”) and the regulations promulgated thereunder (herein referred to as “Treas. reg.”).

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

The technical explanation further notes that trading on one or more recognized stock exchanges may be aggregated for the purpose of meeting the regularly traded requirement.

“Disproportionate class of shares” is defined in article XXIX A(5)(c) to mean a class of shares of a company that is resident in one state that entitles the holder to a disproportionately higher participation in the earnings generated in the other state through dividends, redemption payments, or otherwise. The technical explanation confirms that this concept is intended to include tracking shares. The inclusion of the term “disproportionate class of shares” is intended to prevent a company from being established with primarily US and Canadian shareholders but also with a special class of shares that redirects income that has otherwise been entitled to treaty benefits to residents of a third country.

ARTICLE XXIX A(2)(d): SUBSIDIARY OF A PUBLIC COMPANY TEST

Article XXIX A(2)(d) provides that a company or trust is a qualifying person if five or fewer persons, each of which is a company or trust that is a qualifying person under article XXIX A(2)(c), own directly or indirectly more than 50 percent of the aggregate vote and the value of the shares and more than 50 percent of the vote and value of each disproportionate class of shares (in neither case including debt substitute shares), provided that each company or trust in the chain of ownership is a qualifying person.

For example, a US resident or Canadian resident that is owned, directly or indirectly, by a publicly traded parent that is resident in a third country whose shares are primarily and regularly traded on one or several common stock exchanges in other treaty jurisdictions is not a qualifying person. Therefore, it must satisfy the active trade or business or derivative benefits tests in order to be entitled to the benefits of the treaty.

After the release of the protocol, there were concerns about applying the ownership test in article XXIX A(2)(d) to fiscally transparent entities. The technical explanation indicates that the lookthrough principles introduced by the protocol (for example, under article IV(6)) should be applied in conjunction with the ownership test in article XXIX A(2)(d).²³ When a recipient US-resident company is not the ultimate owner, and there are fiscally transparent US entities between the ultimate US qualifying person

²³ At the 2008 IFA seminar, *supra* note 17, the CRA confirmed that it accepts the lookthrough approach when applying the ownership tests in articles XXIX A(2)(d) and (e) (discussed below). The CRA recommended that the technical explanation reflect this interpretation.

and the recipient, the fiscally transparent US entities should be ignored in determining the qualifying person. For example, assume that a US-resident individual owns a US limited liability company (LLC), which in turn owns a US C corporation, and the US C corporation wishes to obtain treaty benefits in respect of the Canadian-source income it receives. In this case, the US individual is treated as the US C corporation's owner for the purposes of article XXIX A(2)(d). Although this treatment constitutes a logical extension of the lookthrough principles under article IV(6), it is still a welcome clarification from a Canadian perspective.

ARTICLE XXIX A(2)(e): OWNERSHIP TEST

Under article XXIX A(2)(e), a company or trust that is a resident of Canada or the United States is entitled to treaty benefits if it satisfies both an ownership test and a base-erosion test. The ownership test is satisfied if 50 percent or more of the entity's aggregate voting power and value, among other things, is not owned, directly or indirectly, by persons other than qualifying persons. Furthermore, each company in the chain of ownership must be a qualifying person. The technical explanation provides some guidance about how Canada and the United States have agreed to apply the ownership test in article XXIX A(2)(e). However, some inconsistencies remain regarding whether the tests are applied to all entities in the chain of ownership.

The technical explanation states that the ownership test is not satisfied if, for example, a Canadian company is more than 50 percent owned by a US-resident company that is itself wholly owned by a third-country resident. In this case, the Canadian company does not meet the ownership test because more than 50 percent of its shares are indirectly owned by a person (the third-country resident) that is not a qualifying person. This example demonstrates that the indirect ownership test should be applied to each entity in the chain of ownership up to the ultimate parent company to test for the presence of indirect non-qualifying shareholders. The negatively worded test in article XXIX A(2)(e) is contrary to the affirmatively worded test in article 26(1)(d)(i) of the US-Netherlands treaty.²⁴ Under the literal wording of the US-Netherlands treaty, a taxpayer may include as qualifying persons for the purposes of the ownership and base-erosion tests entities that have themselves met the ownership and base-erosion tests, without the need to look further.²⁵ Official commentary that accompanies the US-Netherlands treaty takes the position that a literal reading of article 26(1)(d)(i) is not intended, although a contrary stance is taken in later

24 The Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Washington, DC on December 18, 1992, as amended by the protocols signed on October 13, 1993 and March 8, 2004 (herein referred to as "the US-Netherlands treaty").

25 Richard E. Andersen and Peter H. Blessing, *Analysis of United States Income Tax Treaties* (New York: Research Institute of America) (electronic resource), at paragraph 22.01(2)(c)(i)(2).

commentary.²⁶ This situation implies that a similar interpretation should be applied to the affirmatively worded “directly or indirectly” test in article XXIX A(4)(a) of the Canada-US treaty. In other words, the implication is that it is sufficient if taxpayers look up the chain of ownership until they find a group of indirect shareholders that meets the requirement of this article. This issue is further discussed below in the section entitled “Derivative Benefits Test.”

However, the technical explanation also confirms that if 50 percent or more of the aggregate vote and value of a company that is resident in Canada or the United States are owned by a company described in article XXIX A(2)(c), no further analysis of ownership of the public company’s shares is required for the purposes of applying article XXIX A(2)(e). These two examples provided in the technical explanation are contradictory in nature. In some cases it is necessary to determine ultimate ownership, while in others it is not. It appears that this incongruity represents an attempt to rationalize the result that would have applied if the test were stated in the affirmative, rather than the negative.

In many situations, determining the ultimate ownership of a payee under article XXIX A(2)(e) may be extremely difficult. The difficulty arises because the article requires not only knowledge of the ultimate ownership of the payee but also knowledge of whether the payee meets the income requirements of the base-erosion test.

In a manner similar to that described above in reference to article XXIX A(2)(d), the technical explanation clarifies that the lookthrough principles introduced by the protocol should be applied in conjunction with the ownership test in article XXIX A(2)(e).²⁷ For example, if a US-resident individual owns a US LLC, which in turn owns a US C corporation, the US C corporation also satisfies the ownership requirements in article XXIX A(2)(e).

ARTICLE XXIX A(2)(e): BASE-EROSION TEST

The base-erosion test must also be met in order to qualify for treaty benefits under article XXIX A(2)(e). The intention of this test is to prevent the payment of earnings from Canada or the United States to a resident of a third country if the third-country resident would otherwise benefit, indirectly, from the treaty and no benefit would flow to Canada or the United States.

The base-erosion test requires that the deductible expenses that are paid or payable, directly or indirectly, to persons that are not qualifying persons must be less than 50 percent of the gross income of the relevant entity. The technical explanation defines “gross income” to mean gross receipts less the cost of goods sold. The calculation is based on the preceding fiscal period of the entity, except when the entity is newly formed. In this case, the calculation is based on the current fiscal period.

26 Andersen and Blessing, *ibid.* Compare the United States, Department of the Treasury, Technical Explanation to the US-Netherlands treaty signed on September 24, 2004 with the technical explanation to the protocol.

27 CRA, *supra* note 17.

The words “directly or indirectly” complicate the application of the base-erosion test. Depending on the circumstances, it may not be clear whether there has in fact been an indirect payment. For example, will interpretive tests similar to those that currently apply to the “directly or indirectly” test in subparagraph 95(2)(a)(ii) of the Act be applied in the context of the base-erosion test for Canadian tax purposes? If so, the information required to make such a determination may be difficult or impossible to obtain.

Moreover, should the payments made by a subsidiary of a US parent company or the gross income of the US subsidiary be taken into account when the base-erosion test is applied to the US parent company? Suppose, for example, that the US subsidiary is a member of the US tax consolidated group. Will the US subsidiary’s gross income or its deductible expenses paid to a non-qualifying person be included in the base-erosion computation of the US parent company?

EXAMPLE 1: TAKEOVER OF US COMPANY BY CANADIAN PUBLIC COMPANY

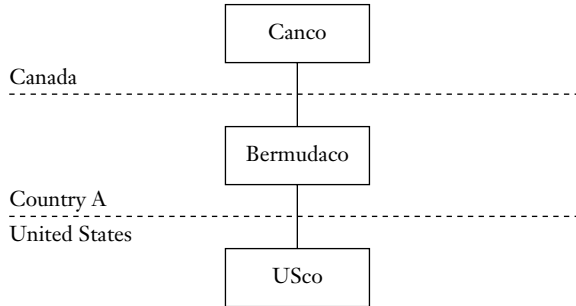
Suppose that Canco, a Canadian public company, is resident in Canada, and its principal class of shares is primarily and regularly traded on the Toronto Stock Exchange. Canco acquires the shares of Bermudaco, a Bermuda company resident in Bermuda. In turn, Bermudaco owns the shares of USco, a US company resident in the United States. The structure is depicted in figure 1. Canco is a qualifying person under article XXIX A(2)(c) because it is resident in Canada and its principal class of shares is primarily and regularly traded on the Toronto Stock Exchange. Because Bermudaco is not a qualifying person (since it is not resident in Canada or the United States), USco is not a qualifying person under articles XXIX A(2)(d) and (2)(e)(i).

Suppose further that Canco makes a downstream interest-bearing loan to USco. As a qualifying person, Canco should be eligible to benefit from the reduced withholding rate under article XI of the treaty on the interest payments from USco.²⁸

Now consider the results if the situation were reversed. USco makes an upstream interest-bearing loan to Canco. In this case, USco is not a qualifying person and is not eligible to benefit from the reduced interest withholding rate on interest payments from Canco, unless it meets the conditions of the active trade or business test in article XXIX A(3) or the derivative benefits test in article XXIX A(4).²⁹ The upstream loan example appears to reveal an inappropriate and inconsistent result when compared with the downstream loan example. Just as the qualifying person test

28 Because the protocol entered into force on December 15, 2008, the rate is reduced to 4 percent in 2009, and to nil in 2010 and onward. Withholding tax on arm’s-length interest has effectively been eliminated in Canada as a result of changes to subsection 212(1) of the Act, which took effect on January 1, 2008.

29 Although articles XXIX A(1) to (5) do not provide USco with the right to Canadian benefits under the treaty, USco can apply to competent authority under article XXIX A(6) to obtain treaty benefits.

FIGURE 1 Takeover of USco by Canco

should not reward treaty shopping, neither should it penalize situations in which no inappropriate treaty benefits are obtained. Given the facts and circumstances, it is reasonable to allow USco to be eligible to benefit from the reduced withholding tax rate on interest payments to Canco because there does not appear to be a benefit to Bermudaco. In fact, if Bermudaco were liquidated, USco would be a qualifying person and would be eligible to benefit from the reduced interest withholding rate on interest payments from Canco.

ACTIVE TRADE OR BUSINESS TEST

A non-qualifying person that is a resident of a contracting state (for example, the United States) may still be entitled to treaty benefits in respect of income derived from the other contracting state (for example, Canada) if

- this person or a related person is engaged in the active conduct of a trade or business in the United States,
- the income derived from Canada is in connection with or incidental to the trade or business, and
- the trade or business in the United States is substantial in relation to the activity carried on in Canada.

The active trade or business test looks not to the characteristics of the person that derives the income but to the circumstances in which the income arises. In doing so, the conditions noted above consider the nature of the person's activity and the connection between the income and that activity.

The active trade or business test does not encompass the business of making or managing investments, unless these 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. In other words, the activities that give rise to passive investment income must occur in the context of an active trade or business as a regulated financial institution. An entity may have passive investment income, provided that it carries on a qualifying trade or business.

Unlike the qualifying person tests, the active trade or business test must be applied separately to each source of income that is earned from the other contracting state (Canada in the situation outlined above).

TRADE OR BUSINESS

The term “trade or business” is not defined in the protocol, and the technical explanation does not elaborate on its meaning. Undefined terms should have the same meaning that they have under the law of the country that applies to the provision. Thus, for US tax purposes, the term “trade or business” should have the same meaning that it has in section 367(a) of the IRC. In general, a trade or business should be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Treas. reg. 1.367(a)-2T(b)(2) further provides that a trade or business is ordinarily a group of activities that includes “every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit,” and ordinarily includes the collection of income and the earning of expenses. Furthermore, a corporation is generally considered to be engaged in the active conduct of a trade or business if its officers or employees (or the officers or employees of related entities, if they are supervised on a daily basis and the related costs are borne by the corporation conducting the trade or business) carry out “substantial managerial and operational activities.”³⁰

However, Canada has not adopted the US interpretation of trade or business, so the term should have the same meaning that it has under the laws of Canada. Although regulation 400(2)(g) uses the term, trade or business is not specifically defined for the purposes of the Act. In earlier Canadian case law, the Supreme Court of Canada established that “profits” and “income from a trade or business” consist of the difference in amount between the receipts from a trade or business and the expenditures necessary to earn these receipts “ascertained on ordinary commercial principles.”³¹ Accordingly, Canadian case law appears to support a broad interpretation of trade or business for Canadian tax purposes.

IN CONNECTION WITH OR INCIDENTAL TO

Similarly, the terms “in connection with” or “incidental to” are not defined in the protocol. At the 2008 IFA seminar, the CRA’s initial comments seemed to suggest that Canadian case law that interpreted the meaning of in connection with or incidental to income from an active business was relevant in considering the scope of

30 Treas. reg. 1.367(a)-2T(b)(3).

31 *Dominion Taxicab Assn. v. MNR*, 54 DTC 1020, at 1021 (SCC); and *Canadian General Electric Co. Ltd. v. MNR*, 61 DTC 1300 (SCC). See also the discussion in Wilfrid Lefebvre, Ian MacGregor, and Deen C. Olsen, “Income Tax Litigation” (1995) vol. 43, no. 5 *Canadian Tax Journal* 1861-79, at 1873.

this provision.³² Such a response suggests a fairly narrow interpretation of these terms. However, the technical explanation does elaborate on the requirement that income from the source country must be derived in connection with or incidental to the trade or business carried on in the resident country.

In Connection with

An item of income is derived in connection with a trade or business if, for example, the income-producing activity in the source country is upstream, downstream, or parallel to the activity conducted in the other country. The technical explanation further explains that if the US activity of a Canadian resident company consists of selling the output of a Canadian manufacturer or providing inputs for the manufacturing process, or consists of manufacturing or selling in the United States the same sorts of products that are sold by a Canadian trade or business in Canada, the income generated by these activities is treated as earned in connection with the Canadian trade or business.

For the purposes of the US model convention, income is derived in connection with a trade or business if an income-producing activity in the source country is a line of business that “forms part of” or is “complementary to” the trade or business conducted in the residence country. The technical explanation to the US model convention³³ also provides the following:

A business activity generally will be considered to form part of a business activity conducted in the State of source if the two activities involve the design, manufacture or sale of the same products or types of products, or the provision of similar services. The line of business in the State of residence may be upstream, downstream, or parallel to the activity conducted in the State of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the State of source, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the State of source.

According to the technical explanation to the US model convention, for two activities to be considered complementary, it is unnecessary that they relate to the same types of products or services; they must, however, be part of the same overall industry and be related in the sense that the success or failure of one activity tends to result in the success or failure of the other. For example, an international airline company and a chain of hotels that are located near airports served by this company

32 At the seminar, *supra* note 17, the CRA suggested that practitioners should refer to Canadian case law, such as *Atlas Industries Ltd. v. MNR*, 86 DTC 1756 (TCC), and *McCutcheon Farms Limited v. The Queen*, 91 DTC 5047 (FCTD), in interpreting the definitions of “incidental” and “pertaining to.” The CRA suggested that there must be a financial relationship between the property and the active business before the income from the property may be considered to be incidental to the active business.

33 United States, Department of the Treasury, Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, at 70.

and used in conjunction with the sale of tour packages that include air travel and lodging at these hotels are complementary businesses. The international airline business and the hotel business are part of the same overall industry (travel), and the links between their operations tend to make them interdependent.³⁴ Similar language and examples can be found in technical explanations to other US treaties.³⁵ However, the technical explanation to the protocol does not contain any discussion or examples of complementary businesses.

In addition, the technical explanation states that income may be considered to be earned in connection with or incidental to an active trade or business in Canada or the United States even if the resident that claims the benefit derives the income, directly or indirectly, through one or more persons that are residents of the other treaty country. For example, the technical explanation states that a Canadian resident can claim benefits with respect to income earned by a US operating subsidiary but derived through a wholly owned US holding company interposed between it and the US operating subsidiary. Presumably, this example refers to dividends ultimately received by the Canadian resident that were earned in connection with the active trade or business carried on by the US operating subsidiary.

On July 16, 2008, following the release of the technical explanation, the CRA released a technical interpretation.³⁶ This document confirms that dividends that are derived by a Canadian resident from its US operating subsidiaries and paid by the Canadian resident to a US holding company are derived in connection with the US trade or business. This interpretation appears to demonstrate that the CRA supports the broad interpretation of dividend income derived in connection with a trade or business that was alluded to in the technical explanation.

The facts included in the technical interpretation are as follows:

- EUco is a corporation resident in a country within the European Union and owns all of the shares of US Holdco.
- US Holdco owns all of the shares of a Canadian corporation (CanULC) and some shares of another ordinary US-resident corporation (USco).
- CanULC is an ordinary Canadian-resident company for Canadian income tax purposes and is a disregarded entity for US tax purposes.
- CanULC owns the remainder of the shares of USco and has no other source of income.

34 Ibid.

35 See, for example, the technical explanation to the US-Netherlands treaty, *supra* note 25; the United States, Department of the Treasury, Technical Explanation to the US-Germany treaty signed on July 17, 2007; the United States, Department of the Treasury, Technical Explanation to the US-Belgium treaty signed on July 17, 2007; the United States, Department of the Treasury, Technical Explanation to the US-Denmark treaty signed on July 17, 2007; and the United States, Department of the Treasury, Technical Explanation to the US-Finland treaty signed on July 17, 2007.

36 Technical interpretation no. 2007-0257021E5, July 16, 2008.

- USco owns all of the shares of various US-resident operating corporations (US Opcos), which carried on active businesses in the United States.
- USco receives dividend income from US Opcos and pays dividends to CanULC, which in turn pays dividends to US Holdco.

The structure is depicted in figure 2.

The issue in question was the applicable rate of Canadian withholding tax for dividends paid by CanULC to US Holdco under the protocol. In determining whether US Holdco was eligible to benefit from the preferential 5 percent dividend withholding tax rate under article X of the treaty, the CRA focused on the active trade or business test. It specifically commented on whether the income in question (the dividend income paid by CanULC to US Holdco) was derived in connection with this US trade or business. Because all or substantially all of CanULC's income was derived from dividends paid by USco (essentially out of dividends received by USco from the US Opcos), the CRA concluded that the dividend income of US Holdco was derived in connection with the US trade or business.

During the 2008 round table,³⁷ the CRA provided an example in which a UK parent corporation owns USco, which in turn owns Canco. USco and Canco each carry on an active trade or business, and USco has a substantial active business in the United States. The active trade or business activities of Canco are the same as or complementary to the active trade or business activities of USco, and all of the fair market value of the shares of Canco is derived from Canco's business activities. The CRA stated that in these circumstances the dividends paid by Canco to USco are considered to be income derived in connection with the active trade or business of USco. This example implies that the CRA is now taking a somewhat broader view than that expressed in its initial comments at the 2008 IFA seminar.³⁸

Some light is shed on Canada's position with respect to dividend income by the technical explanation, the technical interpretation discussed above, the 2008 round table comments, and the 2008 IFA seminar comments. Still, no clear Canadian guidance indicates that in appropriate circumstances interest and other types of income earned by a resident country from a source country can be earned in connection with the active trade or business carried on in the resident country.

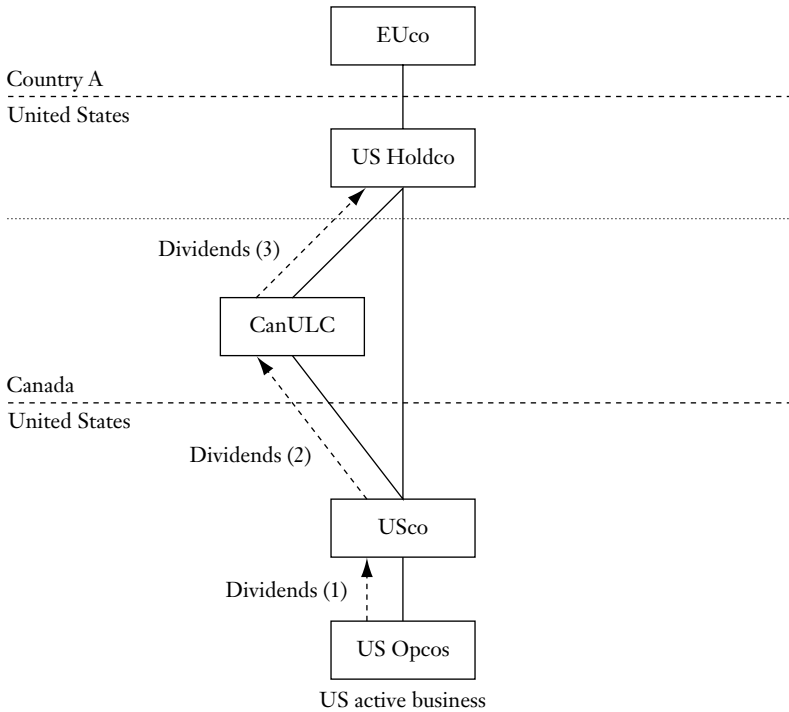
US guidance in this area is more helpful. Several private-letter rulings confirm that interest earned by a financing company is derived in connection with a trade or business if it is attributable to income-producing activities of a group of companies whose line of business forms part of or is complementary to a trade or business of connected affiliates.³⁹ Although the CRA acknowledged that consideration will be

37 *Supra* note 7.

38 *Supra* note 17.

39 See IRS private letter ruling (PLR) 200525002, March 25, 2005, and PLR 200620017, February 9, 2006.

FIGURE 2 Corporate Structure in Technical Interpretation



given to the interpretive approach adopted by the United States, clear written guidance in Canada to support such a broad interpretive approach is lacking.

It is conceivable that the CRA could adopt interpretive tests that resemble the rule in subparagraph 95(2)(a)(i) of the Act. This rule deems payments received by an affiliate to be income from an active business if (1) the income is directly related to an active business carried on by another foreign affiliate in which the Canadian shareholder has a qualifying interest and (2) the amount would be included in computing the earnings or loss from an active business carried on by this other foreign affiliate if the income were earned by it.

The intention of the Department of Finance is apparently to require a more direct connection between the active business income of a paying affiliate and the amount to be recharacterized.⁴⁰ The 1995 *Amendments to the Income Tax Act: Explanatory Notes*⁴¹ states that for subparagraph 95(2)(a)(i) to apply,

40 See Brian J. Arnold, “An Analysis of the 1994 Amendments to the FAPI and Foreign Affiliate Rules” (1994) vol. 42, no. 4 *Canadian Tax Journal* 993-1036, at 1015.

41 Canada, Department of Finance, *Amendments to the Income Tax Act: Explanatory Notes* (Ottawa: Department of Finance, February 1995), subclause 46(4).

[t]here must be a link between the foreign active business activities conducted by the related foreign corporation and the activities conducted by the other foreign corporation that produces income from property. The activities resulting in the income from property must be dependent upon and would not have taken place but for the active business activities taking place. The fact that activities are similar is not enough to demonstrate a link.

If the term “in connection with” in the treaty is interpreted in a manner similar to its interpretation in subparagraph 95(2)(a)(i), then a high degree of connection or dependency must exist between active business income in the source country and active business income in the resident country to establish that one business is upstream, downstream, or complementary to the other business.

In respect of dividend income earned by USco (described above) and capital gains realized by USco on the disposition of shares in a Canco subsidiary (described below), the CRA stated at the 2008 round table⁴² that the active trade or business exception is available to USco if, among other conditions, Canco’s active business is the same as or complementary to the business carried on by USco in the United States.

Incidental to

According to the technical explanation, income is incidental to a trade or business if, for example, it arises from the short-term investment of the working capital of the resident in securities issued by persons in the source country. This interpretation is consistent with the principle expressed in *Ensite Limited v. Her Majesty the Queen*,⁴³ which provides that income from the investment of temporary surplus funds is active business income if the funds are risked in the business. However, the court specified that “‘risked’ means more than a remote risk. A business purpose for the use of the property is not enough. The threshold of the test is met when the withdrawal of the property would ‘have a decidedly destabilizing effect on the corporate operations themselves.’”

SUBSTANTIAL

In addition to the requirement that income be derived in connection with or incidental to an active trade or business in Canada or the United States, a substantiality requirement must also be met to qualify for treaty benefits. This requirement is intended to prevent treaty-shopping abuses that occur when companies attempt to qualify for benefits by engaging in insignificant connected business activities—that is, activities that have little economic cost or effect with respect to the business as a whole.

The technical explanation states that a trade or business in a residence country need not be as large as the income-producing activity in a source country to meet

42 Supra note 7.

43 86 DTC 6521, at 6525 (SCC).

the substantiality requirement. However, in terms of income, assets, or other similar measures, the trade or business in the residence country cannot represent only a very small percentage of the activity in the source country.

EXAMPLE 2: SUBSTANTIALLY OF A US COMPANY

Suppose that a third-country resident establishes USco for the purpose of acquiring Canco, a large Canadian manufacturing company. The sole business activity of USco (other than holding the shares of Canco) is the operation of a small retailing outlet that sells products manufactured by Canco. Does USco meet the substantiality test for the purposes of article XXIX A(3) in respect of the dividends it receives from Canco? Although there is arguably a business connection between the US and the Canadian business, it is unlikely that USco meets the substantiality test.

Under certain US treaties, a safe-harbour rule is provided in addition to the general substantiality test. Consider article 26(4)(b) of the US-Netherlands treaty, for example. Here the substantiality test for the trade or business of the income recipient is deemed to be met when, in the preceding taxation year, the average of the ratios for the three factors listed below exceeds 10 percent, and each of these ratios separately exceeds 7.5 percent:

1. the ratio of the value of assets used or held for use in the active conduct of the trade or business by the income recipient in its residence country to the value of such assets used or held for use in the source country,
2. the ratio of gross income derived from the active conduct of the trade or business by the income recipient in its residence country to the gross income derived in the source country, and
3. the ratio of payroll expense of the trade or business for services performed in the residence country to the payroll expense for services performed in the source country.

The foregoing safe-harbour rule mirrors the safe-harbour rule in article 30(2)(b) of the US-France treaty.⁴⁴ Assets, gross income, and payroll expense are taken into account in computing these ratios only if the income recipient has an ownership interest, directly or indirectly, in the source-country entity.⁴⁵

Because no safe-harbour rule is included in article XXIX A(3) of the Canada-US treaty, the substantiality test must be based solely on the relevant facts and circumstances. Since the substantiality condition is intended to prevent certain treaty abuses, it should be applied as an anti-avoidance provision, rather than as a bright-line test.

44 United States, Department of the Treasury, Convention Between the United States of America and France for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, signed at Paris on August 31, 1994, as amended by the protocol signed on December 8, 2004.

45 Ibid. See also the technical explanation to the US-Netherlands treaty, *supra* note 26.

EXAMPLE 3: INTEREST PAYMENTS FROM CANADIAN COMPANY TO US OPERATING COMPANY

Example 3 summarizes some of the issues that arise from the qualifying person and active trade or business tests. Assume Austriaco is resident in Austria, and its principal class of shares is primarily and regularly traded on the London Stock Exchange. Austriaco owns all of the shares of Swissco, a Swiss company resident in Switzerland. Swissco owns all of the shares of Canco, a Canadian company resident in Canada, and all of the shares of US Holdco, a US company resident in the United States. Canco owns all of the shares of USco, a US company resident in the United States. US Holdco owns all of the shares of US Opco, a US operating company that is resident in the United States.

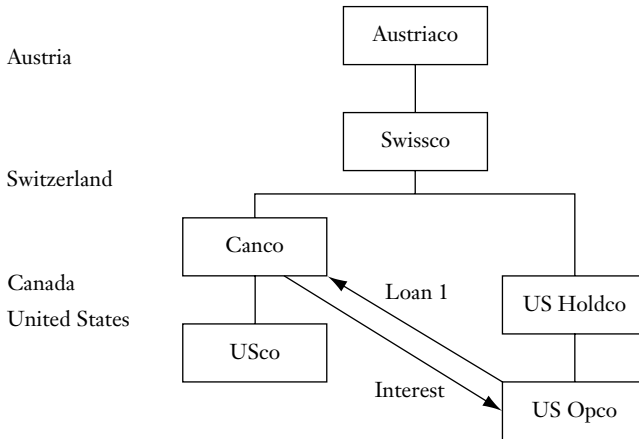
Further assume that US Opco makes an interest-bearing loan to Canco, that Canco's operations are 99 times larger than those of US Opco and all of its affiliated US companies, and that US Opco is engaged in the active conduct of a trade or business in the United States. The structure is depicted in figure 3.

Austriaco and Swissco are not qualifying persons because neither company is resident in Canada or the United States. US Holdco is not a qualifying person under article XXIX A(2)(d) of the treaty because it is owned by Swissco. Because US Holdco is not a qualifying person, US Opco is not a qualifying person for the purposes of article XXIX A(2)(d). As noted previously, the ownership test in article XXIX A(2)(e)(i) requires that 50 percent or more of the vote and value of the shares of US Holdco and US Opco *not* be owned, directly or indirectly, by persons other than qualifying persons. This test cannot be met because Austriaco, Swissco, and US Holdco are not qualifying persons.

However, although US Opco is not a qualifying person, it may still be entitled to treaty benefits under the active trade or business test in respect of the interest income derived from Canco if:

- US Opco or a related person (such as USco) is engaged in the active conduct of a trade or business in the United States,
- the interest income is derived by US Opco in connection with or is incidental to this trade or business, and
- the trade or business is substantial in relation to the activity carried out in Canada.

Because US Opco is engaged in the active conduct of a trade or business in the United States, the first condition should be met. Although the US tax authorities may consider the interest income to be derived by US Opco in connection with or incidental to this trade or business, it is unclear whether the Canadian tax authorities will take the same view. In fact, the Canadian tax authorities may determine that only the returns from the short-term investment of cash from US Opco that is temporarily surplus to its business constitute active business income. This approach is inappropriate because it assigns “in connection with” the same meaning as “incidental to” when, in fact, these phrases represent two different concepts. This differentiation is

FIGURE 3 Interest Payments from Canco to US Opco

apparent from the discussion of the meanings of these terms in the technical explanation. For example, in connection with refers to income-producing activity in a source country that is upstream, downstream, or parallel to the activity conducted in a resident country.

Furthermore, the CRA expressed its view about the dividend income earned by USco or a capital gain realized by USco on the disposition of shares in a Canco subsidiary at the 2008 round table.⁴⁶ The active trade or business exception is available to USco in these circumstances if, among other conditions, Canco's active business is the same as or complementary to the business carried on in by USco in the United States. Presumably USco's capital investment in Canco is not funded with USco's surplus funds; nevertheless, the CRA did not raise a concern about the source of USco's funding. Logically, the CRA should take the same view on interest and other types of income.

Because Canco's operations are 99 times larger than those of the US affiliated group, US Opco may not meet the substantiality test in the third condition, even if Canada takes the position that the test is an anti-avoidance provision, rather than a bright-line test. However, interpretive issues are sure to arise until Canadian tax authorities provide further guidance.

DERIVATIVE BENEFITS TEST

If the qualifying person tests are not met and the exception under the active trade or business test is not met, a further exception in article XXIX A(4), referred to as the derivative benefits test, may give a taxpayer access to certain treaty benefits. Article XXIX A(4) provides treaty relief that is limited to dividends, interest, and royalties

⁴⁶ *Supra* note 7.

received from the other contracting state. However, relief is conditional: the rate of withholding tax that is claimed by the contracting state and the country of residence of the shareholder of the person that claims the benefits must be “at least as low as” the rate provided under the treaty.

Interestingly, Canada is one of only three countries whose treaties with the United States limit the derivative benefits to withholding taxes.⁴⁷ Many of the derivative benefits provisions in US treaties and protocols that entered into force in 2007⁴⁸ or earlier are comprehensive. They provide benefits not only for dividends, interest, and royalties, but also for all classes of income and all tax concessions provided by the treaty, including, for example, an exemption for gains and an exemption for business profits that are not attributable to a permanent establishment.

The limited scope of the derivative benefits provision in the protocol does not appear to be premised on any tax treaty policy. At the 2008 IFA seminar,⁴⁹ the CRA commented that no plans were in place to modify the derivative benefits provision to apply to capital gains. However, this may be a consideration for future negotiations. There appears to be no good reason for limiting the derivative benefits provision to dividends, interest, and royalties. Indeed, the New York City bar’s Committee on Taxation of Business Entities recently proposed the expansion of the protocol’s limited derivative benefit provision to confer comprehensive treaty benefits.⁵⁰

The derivative benefits test in article XXIX A(4)(a) requires that shares (other than debt substitute shares) representing more than 90 percent of the aggregate vote and

47 See article 17(1)(g) of the Convention Between the United States of America and Mexico with Respect to Taxes on Income, signed at Washington on September 18, 1992, as amended by the protocol signed on September 8, 1994, and article 22(3) of the Convention Between the United States of America and Switzerland for the Avoidance of Double Taxation with Respect to Taxes on Income, signed at Washington on October 2, 1996 (herein referred to as “the US-Switzerland treaty”). However, paragraph 7 of the memorandum of understanding to the US-Switzerland treaty, signed on May 14, 1997 and before entry into force, permits more comprehensive derivative benefits.

48 See article 21(3) of the Convention Between the Government of the United States of America and Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Brussels on November 27, 2006, as amended by the protocol signed on November 27, 2006; article 22(3) of the Convention Between the Government of the United States of America and Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Washington on August 19, 1999, as amended by the protocol signed at Copenhagen on May 2, 2006; article 16(3) of the Convention Between the Government of the United States of America and Finland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Helsinki on September 21, 1989, as amended by the protocol signed at Washington on May 31, 2006; and article 28(3) of the Convention Between the United States of America and Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, signed at Bonn on August 29, 1989, as amended by the protocol signed at Berlin on June 1, 2006.

49 *Supra* note 17.

50 *Supra* note 10.

value of (for example, a US company), and at least 50 percent of the vote and value of any disproportionate shares (in neither case including debt substitute shares) must be owned, directly or indirectly, either by qualifying persons or by persons (referred to as “the 90 percent shareholder group”) who satisfy the following three conditions:

1. the person must be resident of a third country with which Canada has a comprehensive tax treaty and be entitled to *all* benefits under this treaty;⁵¹
2. the person must meet the requirements of the qualifying person test or the active trade or business test on the assumption that the person is resident in the United States, and for purposes of the active trade or business test, the business is carried on in the United States;⁵² and
3. the rate of Canadian withholding tax on the income for which benefits are sought must be at least as low under the treaty between Canada and the person’s resident country as under the Canada-US treaty.⁵³

The ownership requirement does not refer to an ultimate ownership test, as some recent US treaties do.⁵⁴ Therefore, the affirmatively worded directly or indirectly test in article XXIX A(4)(a) implies that it is sufficient to look up the chain of ownership until finding a group of indirect shareholders (of the US resident in this case) that meets the requirements of this article.⁵⁵

In addition to the tests in article XXIX A(4)(a), article XXIX A(4)(b) also requires the US company to meet the base-erosion test. The base-erosion test in article XXIX A(4)(b) is identical to the base-erosion test in article XXIX A(2)(e).

EXAMPLE 4: INTEREST PAYMENTS FROM CANADIAN COMPANY TO US OPERATING COMPANY

This example relies on the same facts and assumptions as example 3, with the additional assumption that Swissco is entitled to all of the benefits under the Canada-Switzerland treaty.⁵⁶

51 Article XXIX A(4)(a)(i)

52 Article XXIX A(4)(a)(ii).

53 Article XXIX A(4)(a)(iii).

54 See, for example, article 24(4)(a) of the Convention Between the Government of the United States of America and Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, signed at Luxembourg on April 3, 1996. The ultimate ownership rules generally have been interpreted as requiring that the ownership at the top individual level be tested.

55 This interpretation is supported by the example in the technical explanation, which clarifies that the negatively worded ownership test under article XXIX A(2)(e) should be applied to each entity in the chain of ownership up to the top entity to determine whether there are any indirect non-qualifying shareholders.

56 Convention Between Canada and Switzerland for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, signed at Berne on May 5, 1997 (herein referred to as “the Canada-Switzerland treaty”).

Although US Opco fails the active trade or business test, the interest paid by Canco may still qualify for the treaty rate if more than 90 percent of the total vote and value of all shares of US Opco are 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 that is entitled to all benefits under that treaty.

The first condition cannot be met because US Opco is not owned by a qualifying person. The second condition should be met because Swissco is entitled to all of the benefits under the Canada-Switzerland treaty.

Because the “90 percent shareholder group” test should be met, both of the following tests must also be met under article XXIX A(4)(a):

- Swissco must either meet the requirements of the qualifying person test or the active trade or business test on the assumption that Swissco is resident in the United States, and for purposes of the active trade or business test, the business is carried on in the United States.⁵⁷
- The rate of Canadian withholding tax on the interest income that would otherwise have been imposed on interest paid by Canco to Swissco under the Canada-Switzerland treaty is no greater than the rate of tax under the Canada-US treaty.

Regardless of whether Swissco meets the requirements of the first condition, the company is subject to withholding tax at a 10 percent rate under the Canada-Switzerland treaty; this clearly is not as low as the 4 percent rate under the Canada-US treaty, which became effective on January 1, 2009.⁵⁸ The “at least as low” test is a binary test, meaning that either the test is satisfied and treaty benefits are available, or the test is not satisfied and treaty benefits are not available. Failure to meet the “at least as low as” test seems to result in the complete loss of all treaty benefits, a result that is neither necessary nor appropriate. At the 2008 IFA seminar, the CRA confirmed that this is simply the way the test works.⁵⁹ A number of US treaties include “at least as low as” tests within their derivative benefits provision. Therefore, precedent already exists.

⁵⁷ Article XXIX A(4)(a)(ii).

⁵⁸ The protocol eliminates withholding tax on interest between arm’s-length and non-arm’s-length parties. Because the protocol came into force on December 15, 2008, the rate is reduced to 4 percent effective January 1, 2009; after January 1, 2010, the rate is further reduced to 0 percent. Withholding tax on most arm’s-length interest was effectively eliminated in Canada by domestic changes that took effect January 1, 2008.

⁵⁹ *Supra* note 17.

CAPITAL GAINS: CANADIAN SUBSIDIARIES HELD BY US-RESIDENT COMPANIES

Many foreign-owned US companies are not qualifying persons. As a consequence, to qualify for treaty benefits, these companies must rely on the exceptions in either the active trade or business test or the derivative benefits test. Reliance on these exceptions raises serious concerns when a capital gain is derived by a US resident that is wholly owned by a third-country parent on the disposition of taxable Canadian property (such as the shares of a Canadian subsidiary). Because the active trade or business test may not apply and the derivative benefits test does not apply, the capital gain realized on the disposition of the shares of a Canadian subsidiary by the US company carries a significant risk of double taxation. Such a risk is not necessary to prevent treaty shopping, especially if the ultimate third-country parent is otherwise eligible for treaty benefits.

Before the protocol came into force, a US company was not subject to the LOB provisions, and therefore was exempt from Canadian income tax on the gain under article XIII.⁶⁰ However, once the protocol entered into force, the US company became subject to the LOB provisions and consequently to Canadian tax on the gain. This result is unfair because the gain is also subject to US tax.⁶¹

This problem has two potential solutions:

1. rely on the determination by a competent authority that treaty benefits should be allowed, or
2. establish that the taxable gain on the disposition is in connection with or incidental to an active trade or business under article XXIX A(3).

ACTIVE TRADE OR BUSINESS TEST: APPLICATION TO CAPITAL GAINS

The technical explanation provides no additional insight about whether the scope of the active trade or business test in article XXIX A(3) is limited to income or whether treaty benefits should extend to gains under article XIII. At the 2008 IFA seminar,⁶² a question was raised about whether Canada will allow capital gains to be treated as income that is in connection with or incidental to an active trade or business in applying article XXIX A(3). This question raises two fundamental issues: (1) whether the concept of income in article XXIX A(3) includes capital gains, and (2) whether these

60 For taxes in respect of capital gains, the LOB is effective for taxable years beginning after 2008.

61 The US company does not receive a foreign tax credit for Canadian taxes paid because the capital gain is not generally considered foreign-source income for US tax purposes. If a US company (or a US consolidated group) does not claim a foreign tax credit a deduction may still be available. If a deduction is not available, the Canadian tax paid should be carried forward for 10 years and may be applied as a foreign tax credit against future foreign passive income.

62 *Supra* note 17.

capital gains are income derived in connection with or incidental to the trade or business.

Initially, at the 2008 IFA seminar, the CRA stated that it had not resolved this issue, but indicated that it may be favourably disposed to the inclusion of gains in appropriate circumstances. However, the question and response was removed when the written package from the seminar was subsequently distributed.

During the 2008 round table,⁶³ the CRA confirmed that income for the purposes of article XXIX A(3) can include taxable capital gains. Because the term “income” is not defined in the treaty, it should have the same meaning that it has under Canadian domestic law. Accordingly, income under the Act includes taxable capital gains.

As previously mentioned, the CRA further indicated that it would consider the interpretive approach adopted by the United States. Unfortunately, because a non-resident that disposes of shares of a US company is not subject to US income tax on any gain unless the shares are US real property, no US interpretive guidance is available.

During the 2008 round table, the CRA provided an example in which a UK parent company owns all of the shares of USco, which in turn owns all of the shares of Canco. The CRA confirmed that the active trade or business exception is available to USco if

- USco has a substantial active business in the United States,
- Canco carries on an active business that is the same as or complementary to the business carried on in the United States, and
- all of the value of the shares of Canco is attributable to its active business.

While these comments confirm that capital gains may qualify as income that is derived in connection with an active trade or business in applying article XXIX A(3), the limited ability to rely on this exception creates great uncertainty. For example, suppose that Canco carries on more than one business and that not all of the active trade or business activities of Canco are complementary to the active trade or business activities of USco. In these circumstances, is it necessary to calculate how much of the gain realized by USco on the disposition of the Canco shares is attributable to the complementary business? Alternatively, if USco were purely a holding company, it would not carry on an active trade or business and would fail the test outlined by the CRA.

Furthermore, suppose that Canco carries on an active trade or business that is complementary to the active trade or business carried on by USco, and Canco holds the shares of a foreign Opco that carries on an active trade or business in a third country. The foreign Opco’s active trade or business operations are complementary to the active trade or business operations of both USco and Canco. In this situation, it is not clear that the entire fair market value of the shares of Canco is derived from

63 Supra note 7.

the active trade or business of Canco. These circumstances raise the question of whether Canco's active trade or business operations must be carried solely on in Canada, or whether they can be carried on outside Canada through the active trade or business operations of the foreign Opco in the third country. Arguably, the latter interpretation is correct.

The limited ability to apply the active trade or business exception to a gain realized by a US shareholder (for taxable years beginning after 2008) on the disposition of shares of a Canadian-resident company does not appear to be premised on any tax treaty policy.⁶⁴ As illustrated, treaty benefits in respect of capital gains may be lost without additional guidance from the CRA. Alternatively, more taxpayers may be forced to apply to the Canadian competent authority under article XXIX A(6) for a determination that they should be granted treaty benefits.

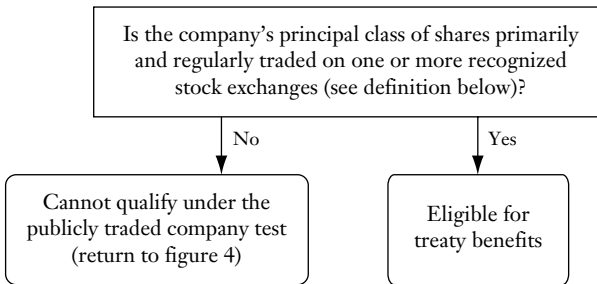
GENERAL ANTI-ABUSE PROVISION

The technical explanation confirms that Canada may apply its domestic GAAR even to US residents that meet all the requirements in the LOB to counter abusive arrangements involving treaty shopping through the United States. Similarly, a Canadian resident that seeks treaty benefits from the United States may meet all of the requirements contained in the LOB, but US tax authorities may still apply their substance-over-form and anti-conduit rules to the Canadian resident. Consequently, merely meeting the objective criteria contained in the LOB provisions does not necessarily guarantee the eligibility of a Canadian or US resident for treaty benefits. Notwithstanding these comments, the CRA likely will have difficulty applying GAAR to perceived treaty-shopping abuse if the objective tests in articles XXIX A(2), (3), and (4) are met.

CONCLUSION

Taxpayers may encounter many interpretive challenges when applying the new bilateral LOB provisions. The most significant challenge is the limited application of the active trade or business exception to a gain realized by a US shareholder on the disposition of the shares of a Canadian-resident company. Although it is too early to anticipate further clarification from Canada on this issue and others, taxpayers will surely demand absolute certainty before entering into real transactions.

64 No public pronouncements from the US Treasury Department or Canada's Department of Finance suggest otherwise.

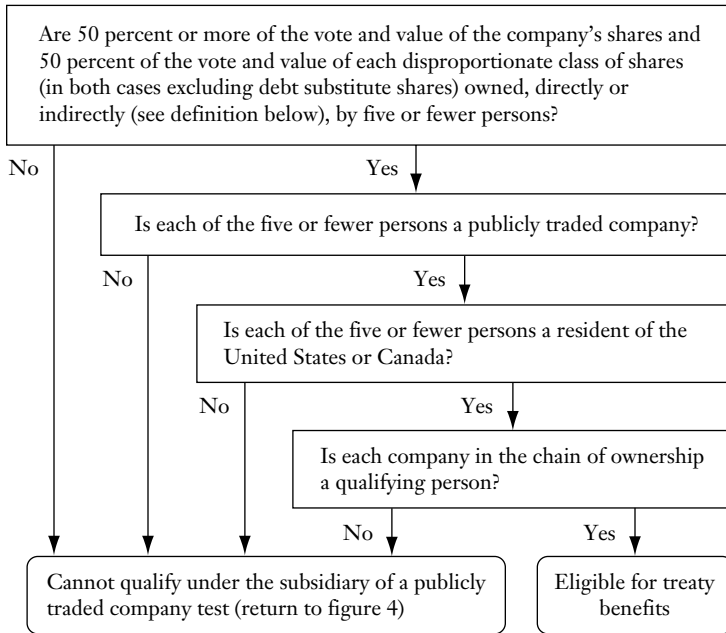
FIGURE 5 Publicly Traded Company Test

“Recognized stock exchange” includes:

- (a) the NASDAQ system owned by the National Association of Securities Dealers and any stock exchange registered with the US Securities and Exchange Commission as a national securities exchange for the purposes of the US Securities Exchange Act of 1934,
- (b) any Canadian stock exchanges that are “prescribed stock exchanges” under the Canadian Income Tax Act, and
- (c) any other stock exchanges agreed upon by the competent authorities of the United States and Canada.

“Principal class of shares” is defined under article XXIX A(5)(e).

“Primarily and regularly traded” is not defined in the treaty. The technical explanation does not define these terms either, but states that Canada will accept the US interpretation. In the case of the United States, the technical explanation indicates that the terms “primarily traded” and “regularly traded” are understood to have the meaning that they have under Treas. reg. 1.884-5(d)(3) and Treas. reg. 1.884-5(d)(4)(i)(B) respectively.

FIGURE 6 Subsidiary of a Publicly Traded Company Test

“Directly or indirectly” means that all companies in the otherwise qualifying chain of ownership are residents of Canada or the United States (see article XXIX A(2)(e)).

FIGURE 7 Ownership and Base-Erosion Tests

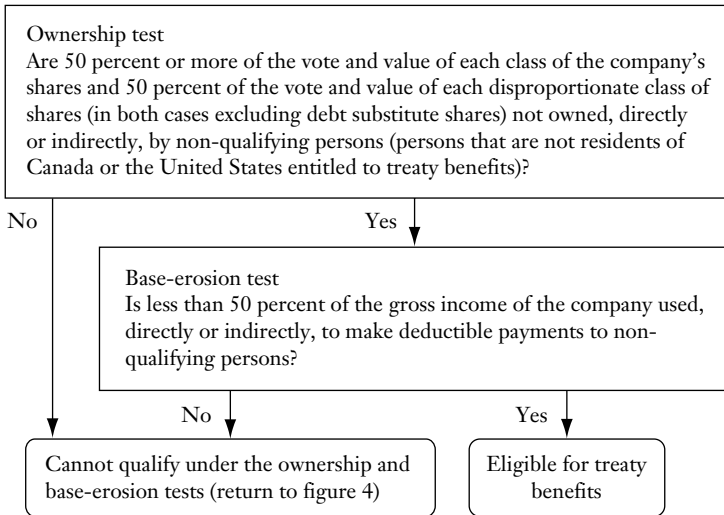


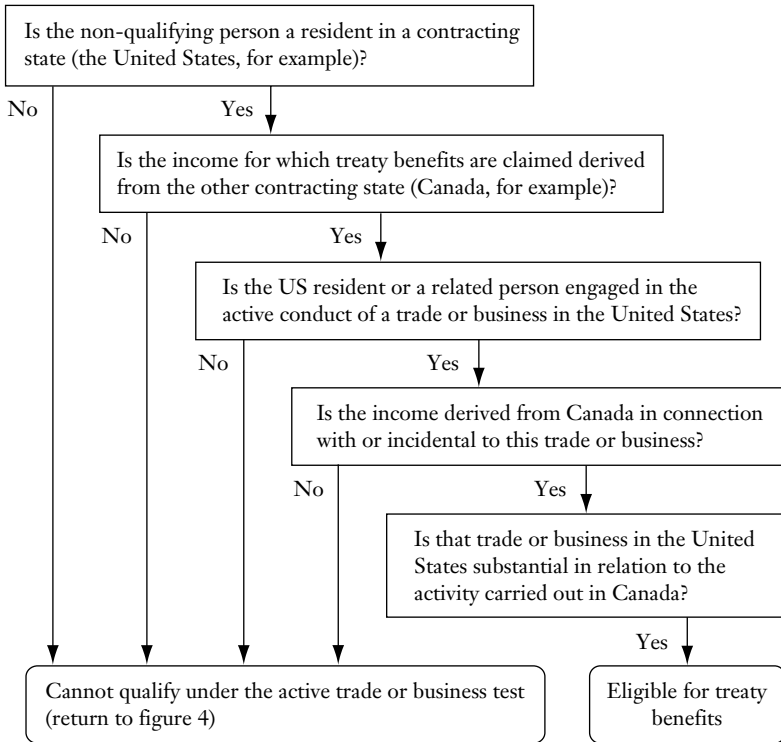
FIGURE 8 Active Trade or Business Test

FIGURE 9 Derivative Benefits Test

