

Thoughts on the New LOB Clause in The Canada-U.S. Treaty

by Steve Suarez

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FEATURED PERSPECTIVES

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The recently enacted fifth protocol to the Canada-U.S. treaty (the treaty) marked the first time that a Canadian tax treaty has included a limitation on benefits clause allowing Canada to restrict general access to treaty benefits by residents of the other signatory.¹ Because Canada and the United States conduct so much cross-border trade with and investment in one another, the LOB article of the treaty is an extremely important provision for both countries.

The primary source of interpretational guidance to date on the treaty is the U.S. Treasury Department's Technical Explanation (TE), reflecting the official U.S. position on its interpretation.² The Canadian government has indicated that as a general matter, the TE "accurately reflects understandings reached in the course of negotiations with respect to the interpretation and application of the various provisions of the Protocol."³

¹Until the fifth protocol, the treaty had an LOB provision that allowed the United States to limit access to treaty benefits, but not Canada. At the May 2009 meeting of the Canadian branch of the International Fiscal Association, Canadian tax officials commented that the inclusion of an LOB clause in the treaty is a byproduct of the particular circumstances of that convention: namely, the virtual elimination of withholding tax on cross-border interest provided for in the treaty. As such, it does not represent a change in Canada's general tax treaty policy, and LOB clauses are unlikely to be sought by Canada in future treaty negotiations with other countries.

²Available at <http://www.treas.gov/press/releases/reports/tecanada08.pdf>.

³See Department of Finance release 2008-052, dated July 10, 2008, available at <http://www.fin.gc.ca/n08/08-052-eng.asp>.

The fifth protocol made a number of important amendments to the treaty, and there are many aspects of these changes that have created interpretational uncertainties for taxpayers and fiscal authorities alike. The LOB article is no exception: There are several instances in which it is not clear where, how, and when these rules apply, even after taking into account the guidance from the TE. Canadian fiscal authorities have made a number of statements as to their interpretation of the LOB rules in the treaty, including:

- various technical interpretations (nonbinding statements made on a no-names basis) issued by the Canada Revenue Agency in the past 18 months or so;
- statements made by officials from the CRA and the Department of Finance at the May 12, 2008, and May 21-22, 2009, meetings of the Canadian branch of the International Fiscal Association (the 2008 IFA meeting and 2009 IFA meeting, respectively);
- statements made by a CRA official at a seminar on June 4, 2009, organized by the Toronto Centre CRA & Tax Professionals Group (the June 4 seminar); and
- materials released by the CRA in May and June 2009 relating to the LOB provisions and the claiming of treaty benefits generally.

These various Canadian administrative developments pertaining to the LOB rules are discussed below, from the perspective of a U.S. resident seeking treaty benefits from Canada.

At the June 4 seminar, the CRA acknowledged the importance of the LOB rules to taxpayers and the need

for guidance in interpreting its provisions. A number of difficult interpretational issues are under consideration by the CRA at this time, and it expects to issue a formal document (perhaps as an Income Tax Technical News publication) in the fall of 2009, possibly in draft form for public comment. This document would be kept current as the CRA's thinking evolves over time and new issues and questions arise.

A general comment made by the CRA at the June 4 seminar was that the CRA would be interpreting these provisions in a purposive manner with regard to the underlying objectives of the LOB article, namely, thwarting abusive treaty shopping. This will certainly be welcome news to taxpayers worried by some of the more technical aspects of the wording of the LOB provisions. However, what constitutes abusive treaty shopping is a matter of considerable judgment, and so taxpayers will need to analyze their circumstances carefully before relying on a claim of treaty benefits.

General Structure

The basic framework of the LOB clause in the treaty (Article XXIX-A) is:

- *Paragraph 1:* a general rule limiting the claiming of treaty benefits to “qualifying persons,” a term defined in paragraph 2.
- *Paragraph 3:* an “active trade or business” exception, allowing a nonqualifying person who is a resident of one of the two countries and engaged in the active conduct of a substantial trade or business in that country to claim treaty benefits with respect to items of income derived from the other country in connection with or incidental to that home-country trade or business.
- *Paragraph 4:* a “derivative benefits” exception, allowing a company that is resident in one of the two countries to claim treaty benefits under articles X (Dividends), XI (Interest), and XII (Royalties) if 90 percent or more of the company's shares (by votes and value) are held (directly or indirectly) by persons who are either qualifying persons or residents of countries with which the other country has a tax treaty providing benefits for the relevant item of income as good or better than those provided for under the treaty.⁴
- *Paragraph 6:* a residual exception, allowing a person that is a resident of one of the two countries and is not otherwise entitled to treaty benefits under the LOB rules to claim treaty benefits, when the competent authority of the other state determines that either:

- the person's creation and existence did not have as a principal purpose the obtaining of treaty benefits not otherwise available; or
- it would be inappropriate to deny treaty benefits to that person.

- *Paragraph 7:* a residual clause stating that nothing in the LOB article will be construed as restricting a country's right to deny treaty benefits when it can reasonably be concluded that doing otherwise would result in an abuse of treaty provisions.

This framework is summarized in Figure 1 from the perspective of a U.S. resident seeking treaty benefits from Canada, which is the focus of this article.

Article XXIX-A(1): Qualifying Persons

The qualifying persons test is the basic manner in which a resident of one of the two countries obtains treaty benefits from the other. A company (as distinct from natural persons, governmental entities, trusts, not-for-profits, and some charitable or pension-related entities) essentially constitutes a qualifying person if it is resident in Canada or the United States and it meets at least one of three tests:

- (1) its principal class of shares is primarily and regularly traded on a recognized stock exchange;
- (2) more than 50 percent of the company's shares (by votes and value) is directly or indirectly owned by five or fewer persons described in (1), provided that each person in the chain of ownership is a qualifying person; or
- (3) 50 percent or more of the company's shares (by votes and value) is *not* owned (directly or indirectly) by persons who are *not* qualifying persons.⁵

Recognized Stock Exchanges

Companies resident in Canada or the United States can be qualifying persons by virtue of their principal class of shares being primarily and regularly traded on a recognized stock exchange.⁶ The term “recognized

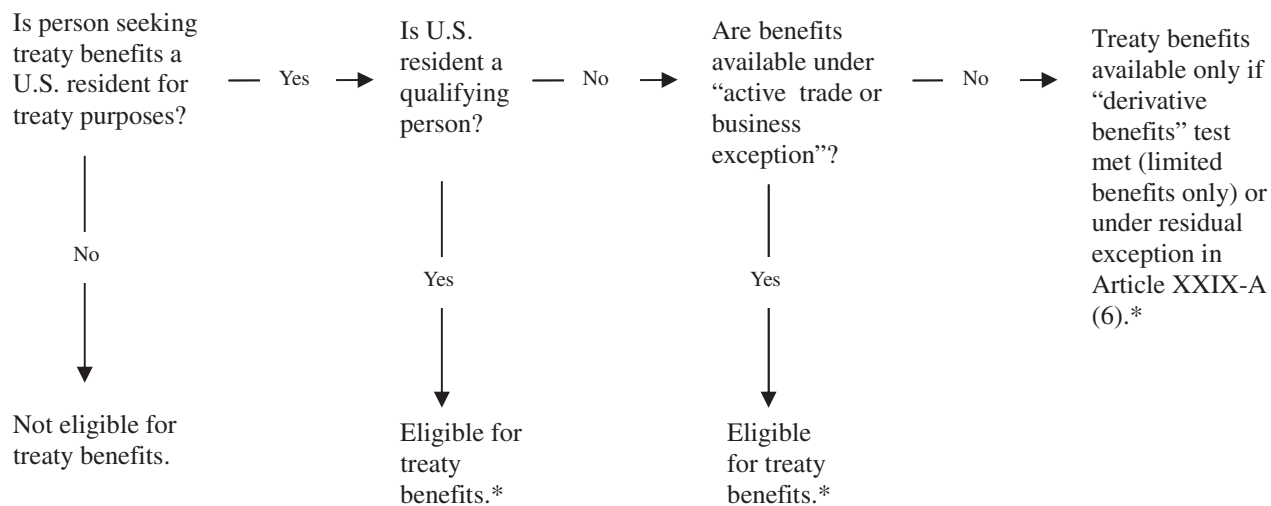
⁵A base erosion test applies to require that the amount of expenses deductible from the company's gross income and payable (directly or indirectly) to persons who are not qualifying persons be less than 50 percent of such gross income. An essentially identical base erosion test is discussed *infra* in the context of the derivative benefits exception. For a detailed discussion of the qualifying person concept, see Michael Colborne and Shawn Porter, “The Limitation on Benefits Article in the Fifth Protocol to the Canada-United States Tax Convention (1980),” *2008 Conference Report* (Toronto: Canadian Tax Foundation, 2009), 25:1.

⁶The TE indicates that Canada intends to adopt the U.S. interpretation of “regularly traded” and “primarily traded” taken from the branch tax provisions of the U.S. Internal Revenue Code, subject to reserving the right to adopt different definitions. A further trading test must be met if the company has a class of

(Footnote continued on next page.)

⁴This exception is the subject of a base erosion antiavoidance rule directed at expenses payable by the company to persons who are not qualifying persons.

Figure 1. Limitation on Benefits: Summary of Analysis



* Availability of treaty benefits subject to antiabuse rules as per Article XXIX-A (7).

stock exchange” is defined to mean NASDAQ and any stock exchange registered with the U.S. Securities and Exchange Commission as a national stock exchange, and (in Canada) the Toronto and Montreal exchanges, the Canadian National Stock Exchange, and Tiers 1 and 2 of the TSX Venture Exchange.⁷ While provision exists for the signatories to designate other recognized stock exchanges, at present there are no recognized stock exchanges outside Canada and the United States.

Fiscally Transparent Entities

Subsidiaries of public companies would look primarily to test (2) above to establish themselves as qualifying persons. However, only subsidiaries of a public company that is resident in Canada or the United States will so qualify, because a public company resident in a third country cannot be a qualifying person and so cannot be a person described in test (1), above, for purposes of the test in (2). U.S. or Canadian resident subsidiaries of a public company resident in a third country will generally not be qualifying persons, although they may qualify for full or limited treaty benefits under one of the exceptions in the LOB rules.

shares entitling a holder resident in one contracting state to a disproportionately higher share of earnings generated in the other state.

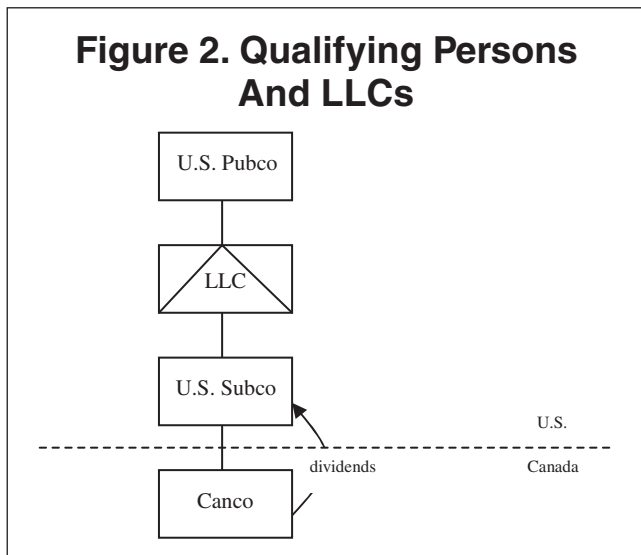
⁷The current list of designated stock exchanges can be found at <http://www.fin.gc.ca/act/fim-imf/dse-bvd-eng.asp>.

In the case of both subsidiaries owned *indirectly* by a qualifying public company in test (2) and making a direct or indirect ownership determination in test (3), there had been some question about whether the inclusion of a limited liability company in the chain of ownership would cause the qualifying person test not to be met. Specifically, since most LLCs are fiscally transparent for U.S. tax purposes, the CRA has historically maintained that they are not U.S. residents for treaty purposes because they are not themselves liable to pay U.S. tax (although this has never been tested before the courts). An LLC that is not a U.S. resident cannot be a U.S. qualifying person by definition.

New Article IV(6) of the treaty (also part of the fifth protocol) addresses amounts earned by a resident of one contracting state through an entity that is treated as fiscally transparent under the laws of that state. The primary example is an LLC that is fiscally transparent for U.S. tax purposes and that has a U.S. resident shareholder. Article IV(6) provides that an item of income will be considered to be derived by a U.S. resident when both:

- under U.S. tax law, the U.S. resident is considered to have earned the income “through” another entity (other than a Canadian resident entity) such as an LLC; and
- by reason of the entity’s fiscal transparency for U.S. purposes the U.S. tax treatment is the same as if the U.S. resident had earned the income directly.

The TE suggests that in applying tests (2) and (3) of the qualifying persons test in the LOB article, the look-through rules in Article IV(6) should be incorporated, such that entities that are transparent under the laws of the state of residence (other than entities resident in the source state) should be looked through. In the structure in Figure 2, for example, the inclusion of an LLC in the chain of ownership should be effectively ignored.



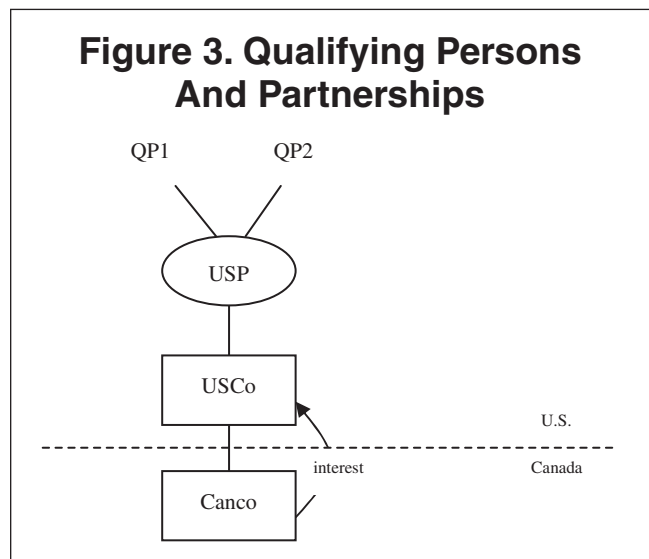
At the June 4 seminar, the CRA confirmed that it agrees with this approach, and that as a result it would treat U.S. Pubco as the owner of the shares of U.S. Subco for purposes of test (2). This is consistent with comments previously made by the CRA that they will look through fiscally transparent entities in applying tests (2) and (3) above (including as to the base erosion test in (3)).⁸

A similar approach should generally apply to other entities that are treated as fiscally transparent for treaty purposes, such as partnerships. The CRA has stated that it considers an entity to be fiscally transparent for treaty purposes if its income is taxed at the level of its members, shareholders, or beneficiaries (that is, “up” a level).⁹ Partnerships are an obvious example. Figure 3 illustrates the principle that when the ultimate stakeholders are qualifying persons, the interposition of a

⁸See CRA Document No. 2008-0272361C6, dated July 17, 2008, memorializing comments made by the CRA at the 2008 IFA meeting.

⁹See CRA Document No. 2007-0261901C6, dated July 17, 2008, also summarizing comments made at the 2008 IFA meeting.

partnership in the ownership chain should not affect USCo’s claim to qualifying person status under test (3), for example.



Under Article IV(6), when the partnership is treated as a U.S. resident by virtue of checking the box to be taxable in the United States as a C corporation, the CRA will treat it as a U.S. resident that can itself meet the qualifying person test under the LOB rules and produce an entitlement to treaty benefits. However, if the partners of such a partnership are entitled to better treaty benefits than the partnership itself and are themselves qualifying persons for LOB purposes, the CRA is willing to look through that partnership and let the partners claim treaty benefits directly on the partnership’s income; that is, the best of both worlds.¹⁰

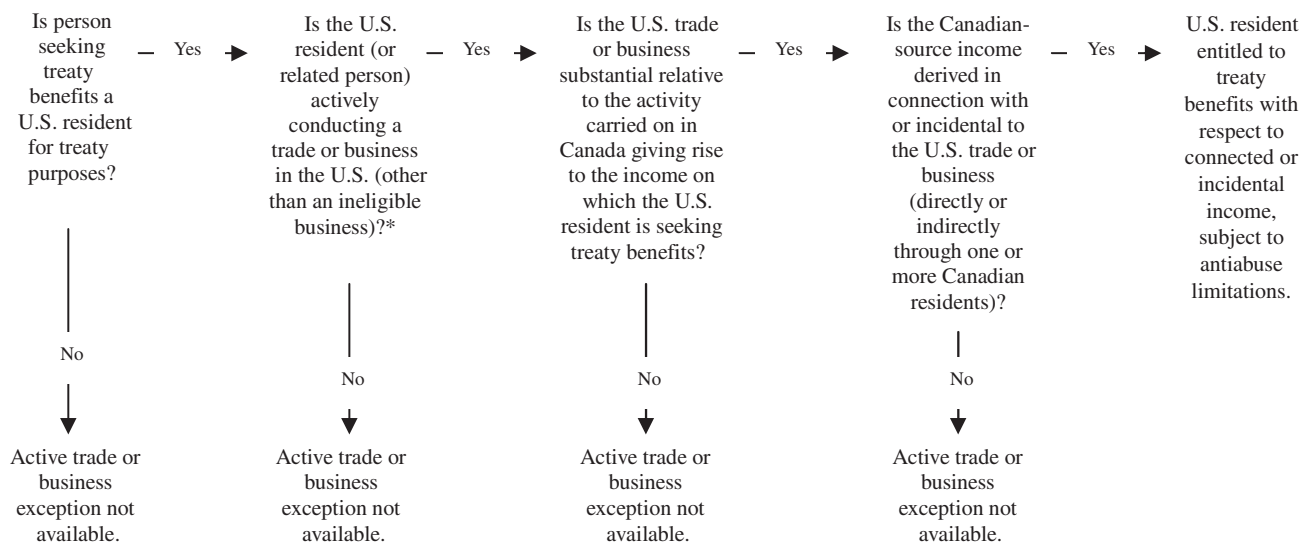
Despite having some similarities with LLCs, S corps have consistently been treated by the CRA as U.S. residents. The CRA accepts that an S corp is entitled to treaty benefits in its own right, assuming that it is a qualifying person.¹¹ However, the TE for Article IV(6) also acknowledges that the S corp will be treated as fiscally transparent, a conclusion that the CRA has accepted.¹² As such, logically an S corp should be looked through in determining the qualifying person status of

¹⁰See CRA Document No. 2008-0272871C6, dated July 18, 2008.

¹¹See CRA Document Nos. 2009-0319481E5, dated June 1, 2009, and 2007-0261911C6, dated July 18, 2008. This means that an S corp receiving Canadian-source dividends could be eligible for the 5 percent rate provided for in the treaty for companies owning 10 percent or more of the voting shares of the dividend payer.

¹²*Id.*

Figure 4. Active Trade or Business (ATB) Test Summary



* An ineligible business is the making or managing of investments, unless carried on with customers in the ordinary course of business by a bank, insurance company, registered securities dealer, or deposit-taking financial institution.

other persons for LOB purposes. (Given the limitations on permissible shareholders for an S corp, one would expect that it should be owned by qualifying persons in any event.)

Article XXIX-A(3): Active Trade/Business

The primary manner in which a nonqualifying person can claim treaty benefits is under the active trade or business (ATB) exception in Article XXIX-A(3). In the context of a U.S. resident for treaty purposes (USCo) seeking treaty benefits from Canada, the ATB exception can be paraphrased as being applicable in the following circumstances:

- either USCo or someone related thereto is engaged in the active conduct of a trade or business in the United States (the “U.S. business”), other than making or managing investments¹³;
- USCo derives income from Canada (the “Canadian income”) in connection with or incidental to the U.S. business, either directly or through Canadian residents; and

- the U.S. business is substantial in relation to the Canadian activity that generates the Canadian income.

The ATB analysis is depicted in Figure 4.

The essence of the provision is that when a U.S. resident (or related person) is carrying on a substantial U.S. business, there is little treaty shopping concern regarding Canadian-source income derived (directly or indirectly) by the U.S. resident that has some connection with the U.S. business.

Eligible Business

A trade or business of making or managing investments is not eligible to support treaty benefits under the ATB exception, unless those activities are carried on with customers in the ordinary course of business by a bank, insurance company, registered securities dealer, or deposit-taking financial institution. At the June 4 seminar, the CRA offered some comments as to how this element of the ATB exception will be interpreted.

The question was asked whether related persons can be included as customers of banks and other financial institutions allowed to make or manage investments. The CRA agreed that customers could include related parties, although the situation in which *all* customers were non-arm’s-length persons had not been considered. The CRA’s position seems well supported by the text of the provision, which (unlike some other U.S.

¹³Only banks, deposit-taking financial institutions, insurance companies, and securities dealers can treat making or managing investments as an active trade or business for this purpose.

treaties) does not refer to customers as being non-arm's-length. It may be the case that to meet the ordinary course of business element of the test for making or managing investments, related-party customers would need to deal with the financial institution on arm's-length terms.

The CRA was also asked if the term "registered securities dealer" would be interpreted with reference to the definition of that term in the Income Tax Act (Canada), which requires registration under provincial securities laws,¹⁴ or conversely whether that term might include a U.S. resident actively trading securities but not registered in Canada. The CRA acknowledged that the registered securities dealer definition in the ITA was probably not appropriate to apply in the ATB exception, and indicated that guidance on the meaning of this term would be released soon. In a technical interpretation subsequently released, the CRA indeed said it would interpret the term "registered securities dealer" more broadly as encompassing someone who either comes within the ITA definition of that term or the definition of a dealer in securities under IRC section 475 (and whose dealings as such are regulated under U.S. federal or state securities legislation).¹⁵ As such, it will be possible for a U.S. dealer that is not licensed in Canada to qualify.

Substantial Business

To support a claim of treaty benefits under the ATB exception, the U.S. business must be substantial in relation to the activity generating the Canadian income. The TE offers little guidance in terms of explaining what substantial means, with only a single example in which the party claiming treaty benefits operates a single outlet selling only a few of the goods manufactured in the source country.

Participants at the June 4 seminar noted that some U.S. treaties contain safe harbor rules setting out a bright-line test that if met constitutes a substantial level of activity for ATB purposes. The example given was the safe harbor in article 30(2)(b) of the France-U.S. treaty, in which meeting asset value, gross income, and payroll ratios in the preceding year or on the average of the three preceding years means the residence country business will be considered substantial relative to the source-country activity.

Not surprisingly, the CRA rejected the relevance of safe harbor tests in other treaties in interpreting the substantiality requirement of the treaty, which contains

no references to safe harbors. Citing the text of the TE, the CRA remarked that the size of the U.S. business need not be as large as the activity generating the Canadian income, but "cannot represent only a very small percentage" of that Canadian activity.¹⁶

Income Derived 'In Connection With'

The ATB exception extends treaty benefits to Canadian-source income derived "in connection with or incidental to" the U.S. business (directly or indirectly through Canadian resident persons). In many cases the most difficult determination to make will be whether the Canadian income is sufficiently connected with the U.S. business to meet this test.

The primary source of guidance is the accompanying portion of the TE, which reads:

ATB TE Excerpt 1

[Note: References to Canada and the U.S. have been reversed, to be consistent with our fact pattern.]

Income is considered derived "in connection" with an active trade or business if, for example, the income-generating activity in the State is "upstream," "downstream," or parallel to that conducted in the other Contracting State. Thus, for example, if the [Canadian] activity of a [U.S.] resident company consisted of selling the output of a [U.S.] manufacturer or providing inputs to the manufacturing process, or of manufacturing or selling in [Canada] the same sorts of products that were being sold by the [U.S.] trade or business in [the U.S.], the income generated by that activity would be treated as earned in connection with the [U.S.] trade or business.

These examples describe relatively unusual fact patterns in which U.S. residents are earning Canadian-source business income directly (that is, through a branch). More typical will be the situation when income is being earned by a U.S. resident *indirectly*, through one or more other entities. The TE is vitally important in this regard, making clear as it does that the Canadian income need not be the actual item of income that the U.S. resident is seeking treaty benefits on, but rather some other income generated in Canada further down the chain:

ATB TE Excerpt 2

[Note: References to Canada and the U.S. have been reversed, in order to be consistent with our fact pattern.]

¹⁴Subsection 248(1) ITA defines this term as a person registered or licensed under the laws of a province to trade in securities (as agent or principal) without restriction as to the type of securities.

¹⁵CRA Document No. 2009-0319161I7, published June 30, 2009.

¹⁶The TE uses "income, assets, or other similar measures" as a basis for measurement. Note the absence in the TE of any language corresponding to that in the technical explanation to the U.S. model treaty, which allows the relative size of the two countries to be taken into account.

An item of income may be considered to be earned in connection with or to be incidental to an active trade or business in the United States or Canada even though the resident claiming the benefits derives the income directly or indirectly through one or more other persons that are residents of the other Contracting State. Thus, for example, a [U.S.] resident could claim benefits with respect to an item of income earned by a [Canadian] operating subsidiary but derived by the [U.S.] resident indirectly through a wholly-owned [Canadian] holding company interposed between it and the operating subsidiary.

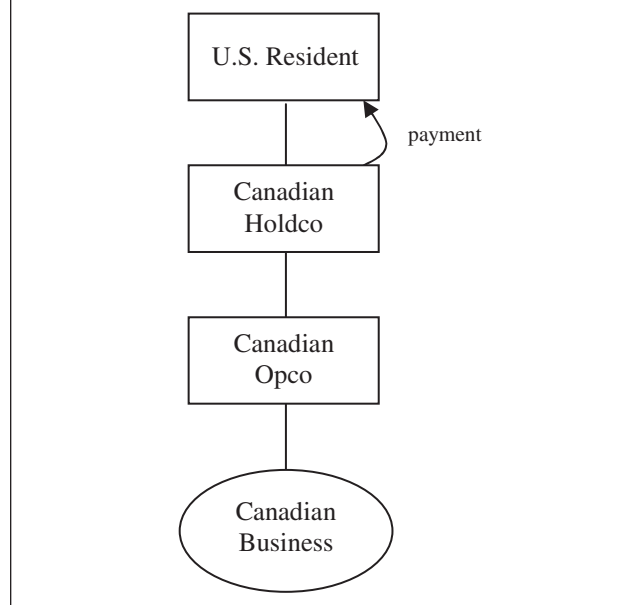
This is extremely important, because in many cases the U.S. resident will be seeking treaty benefits on a form of income that is not business income (for example, dividends or interest) and which is therefore by its very nature harder to establish as being connected to the U.S. business carried on by the U.S. resident. In cases such as those described in the TE, we may look through the item of income that the U.S. resident is earning directly, down to some other item of income that may be much easier to connect to the U.S. business. In this example from the TE (depicted in Figure 5), treaty benefits are almost certainly being sought on dividend or interest income paid by Canadian Holdco to the U.S. resident (what other Canadian-source income would a U.S. shareholder in the Canadian holding company earn). However, for purposes of the ATB analysis, the Canadian income is the income earned by Canadian Opco, not the payment actually received by the U.S. resident for which treaty benefits are actually being sought.

There has been very little guidance to date from the CRA as to what degree of linkage there must be between the income received by the U.S. resident (that is, the income on which treaty benefits are being sought) and the Canadian income being earned “down the chain” (that is, by Canadian Opco in this example) such that the U.S. resident can be said to be deriving the latter indirectly.¹⁷ For example:

- Does the underlying income actually need to be paid up the chain to fund the payment received by the U.S. resident, or is a chain of ownership enough?

¹⁷The CRA has released one technical interpretation (CRA Document No. 2007-0257021E5, dated July 16, 2008) dealing with a case of indirect earnings. However, the facts of that case were straightforward and very favorable for reaching a positive conclusion: There were actual back-to-back payments up the chain, the underlying income from which the Canadian-source dividends were being paid was generated by the U.S. business itself, and there appear to have been no intervening expenses. One interesting point in this technical interpretation, however, was that the CRA was willing to look through not only source-country residents in the income derived indirectly analysis but also U.S. resident entities.

Figure 5. Income Derived Indirectly



- When there are multiple sources of income in the indirect ownership chain (for example, Canadian Opco has various activities), how do we know what portion of the payment received by the U.S. resident represents the income from the particular activity that is connected to the U.S. business?
- If entities within the relevant chain of indirect ownership (for example, Canadian Holdco) have expenses or liabilities that could conceivably amount to an indirect claim on the underlying income, how do these affect the analysis?

Thus, there remain a number of important questions as to the scope of the “income derived indirectly” element of the ATB exception.

Applying the “income derived indirectly” principle to the examples from the TE described above in ATB TE Excerpt 1, it should be the case that a U.S. resident carrying on a substantial U.S. business (either itself or via a related person) can earn interest or dividend income eligible for treaty benefits under the ATB exception of Article XXIX-A, if:

- there is a sufficient nexus between the interest/dividend income and the Canadian income such that the U.S. resident can be said to be deriving the latter indirectly by virtue of earning the former; and
- the Canadian income is itself is considered to be derived “in connection with or incidental to” the U.S. business, a determination that the TE says is made with reference to the activity that generates the Canadian income.

Figure 6. Summary of the ATB Analysis

<p>1. Identify relevant item of income (i.e., the Canadian income) to be tested for “connectedness.”</p> <ul style="list-style-type: none"> • “Directly or indirectly” principle allows us to look through the actual item of income earned by the U.S. resident, to income earned “down” the ownership chain. 	→	<p>2. Identify the activity generating the relevant item of income.</p>	→	<p>3. Establish whether the income-generating activity is sufficiently connected to any U.S. active trade or business of the U.S. resident or a related party.</p> <p>Examples:</p> <ul style="list-style-type: none"> • selling the output of the U.S. business; • selling inputs to the U.S. business; • making/selling same products or services as in the U.S. business; and • making/selling products or services complementary to the U.S. business.
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Incorporating the guidance from the TE into the analysis, the framework for making a connectedness determination is set out in Figure 6.

Grafting the “income derived indirectly” principle onto the examples provided in ATB TE Excerpt 1 (cited above), we can restate those examples to illustrate how a U.S. resident (USCo) could earn Canadian-source interest or dividend income eligible for the ATB exception by virtue of being considered to derive such amounts indirectly in connection with a U.S. trade or business. (See Figure 7.)

The third of these examples is particularly interesting, because unlike the other two it does not involve economic interaction between the U.S. business and the activity generating the Canadian income, but merely similarity in the activities.

The CRA made some interesting comments on some aspects of the “in connection with” element of the ATB exception at the June 4 seminar. First, the CRA noted that in the technical explanation to the LOB article in the U.S. model treaty, activities that are complementary to the U.S. business are stated to be connected with the U.S. business.¹⁸ In contrast, the TE makes no such reference. Complementary activities are described in the U.S. model TE as “[not necessarily relating] to the same types of products or services, but they should be part of the same overall industry and be

related in the sense that the success or failure of one activity will tend to result in success or failure for the other.” Examples of complementary activities given in the U.S. model TE include:

- an airline that also operates a hotel chain, with some customers being sold packages that include both air travel and hotel accommodation; and
- a flower production and sale business and a lawn care products business, where sales from one business tend to increase sales in the other.

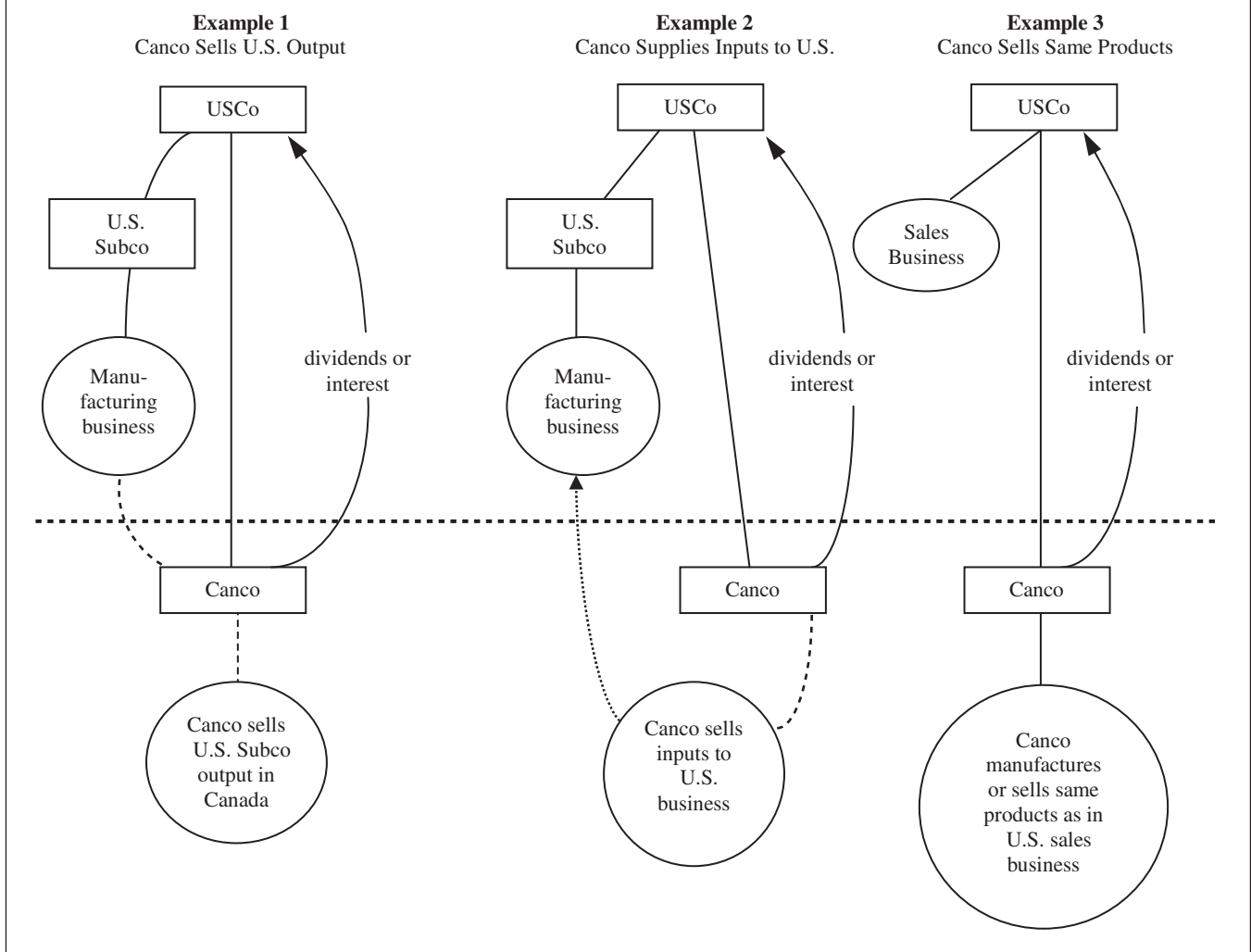
The CRA confirmed at the June 4 seminar that it will consider complementary activities so described in the U.S. model TE to come within the scope of the “in connection with” test in the ATB exception under the treaty.

The CRA was also asked as to its position about capital gains realized by a U.S. resident on the sale of shares of a Canadian corporation when only *part* of the value of those shares is attributable to an activity that is connected with the U.S. business. The reply was that some form of apportionment of the gain would need to be made between that relating to a connected activity (for which the ATB exception could apply) and the remainder, using some kind of common-sense approach. No specific approach for apportioning the gain appears to have been developed as yet. The CRA noted that the remainder of the gain not eligible for the ATB exception might be the subject of treaty benefits under the residual rule in Article XXIX-A(6) (discussed below). Interestingly, the CRA remarked that apportionment may also be necessary in similar circumstances involving interest and dividends, although without further elaboration on this possibility. Hopefully, the CRA will provide further insight into its thinking on these points.

Finally, the CRA commented that it had not yet formed a view on the extent to which the ATB exception (which is phrased in terms of “income derived

¹⁸“An item of income is derived in connection with a trade or business if the income-producing activity in the State of source is a line of business that ‘forms a part of’ or is ‘complementary’ to the trade or business conducted in the State of residence by the income recipient.” United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of Nov. 15, 2006, article 22, paragraph 3, available at <http://www.treas.gov/offices/tax-policy/library/TEMod006.pdf>.

Figure 7. Restated TE Examples



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from the other Contracting State”) could apply to capital gains on the shares of a Canadian corporation, when some or all of those gains are attributable to businesses carried on by third-country subsidiaries of the Canadian corporation. Again, this is an important issue that requires administrative attention as soon as possible, particularly as similar concerns may also arise regarding dividends or interest payable by such a Canadian corporation.

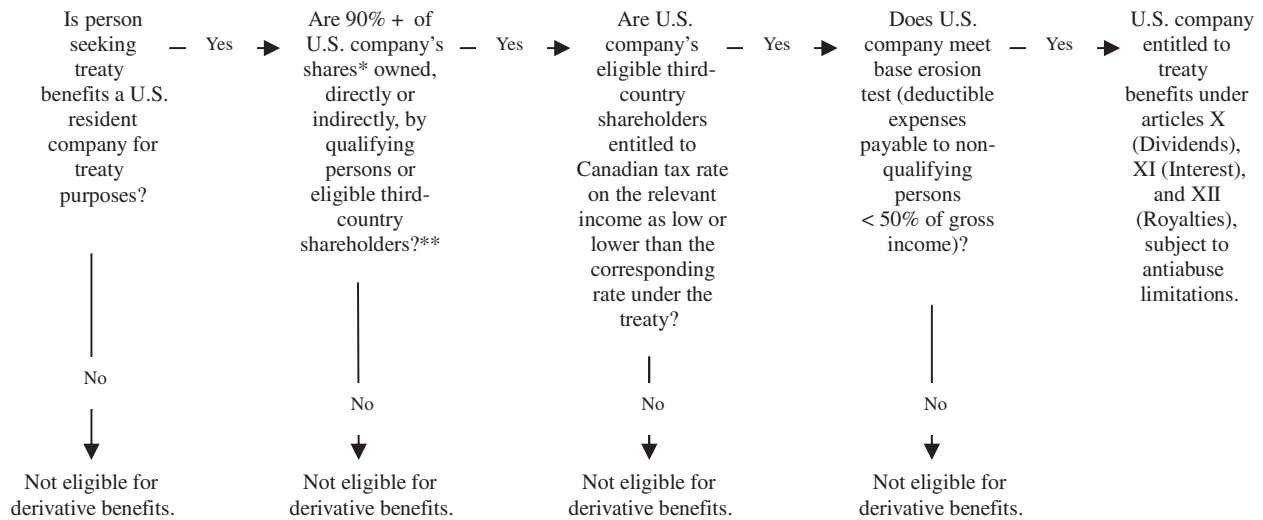
Article XXIX-A(4): Derivative Benefits

A U.S. resident company that is not able to claim treaty benefits as a qualifying person or under the ATB exception may be able to claim limited treaty benefits (interest, dividends, and royalties only) under Article XXIX-A(4), the derivative benefits article. The essence of this test is to look to the shareholder(s) of the U.S.

company, and ask whether, if they had earned the relevant income rather than the U.S. company, they would have been entitled to a rate of Canadian taxation as low or lower than the U.S. company would be if it were entitled to treaty benefits on such income. If so, as a general rule there is no treaty-shopping concern and the U.S. company will get treaty benefits.

Since the treaty is the only Canadian tax treaty with a zero withholding rate on most forms of interest payments (that is, no other treaty has as good a rate), derivative benefits are likely to be relevant only in the case of dividends and royalties. It is not intuitively obvious as a matter of tax policy why derivative benefits should be limited to only these three forms of income, but Canadian tax officials have previously indicated there are no plans to seek an expansion of this provision to other forms of income (for example, capital

Figure 8. Derivative Benefits Test Summary



* “Debt substitute shares” are ignored under this test, and a further test applies if a “disproportionate class of shares” exists.

** An eligible third-country shareholder is a resident of a third country entitled to full benefits under a treaty between Canada and that third country, and who (if resident in the U.S.) would either be a qualifying person under the Canada-U.S. treaty or eligible for treaty benefits under the “active trade or business” test (if it was assumed that the shareholder carried on in the U.S. the same business it in fact carries on in the third country).

gains or guarantee fees), although it will be considered in future treaty negotiations.¹⁹

The treaty’s derivative benefits rule is an all-or-nothing test that will either produce the Canada-U.S. rate under the treaty or no relief whatsoever from the 25 percent rate provided for under Canadian domestic legislation. For example, when a U.S. company earning dividend income from Canada would be entitled to a 5 percent withholding rate under the treaty (if the LOB provisions are satisfied) and its shareholder would be entitled to a Canadian tax rate under its home country’s tax treaty with Canada (if it had earned the income itself) higher than the 5 percent Canada-U.S. rate but lower than 25 percent, the 25 percent rate applies. One might have thought as a tax policy matter that if all the other elements of the treaty’s derivative benefits test are met, there would be no reason not to reduce the Canadian tax rate down to what the third-country shareholder would have paid had it earned the income directly. However, a Department of Finance official

confirmed in 2008 that the all-or-nothing aspect of the test is simply how the derivative benefits rule works.²⁰

The derivative benefits exception (as applied in Canada) is available only to companies (not other entities) that are resident in the U.S. for treaty purposes, and only then when further tests are met based on who the company’s shareholders are and how much its expenses are (and to whom they are owed). The derivative benefits test is summarized in Figure 8.

The principal test under the derivative benefits rule is establishing that 90 percent or more (by votes and value) of the U.S. company’s shares are held by eligible persons. Because this share ownership test is stated as a direct or indirect test rather than one of ultimate ownership (as is sometimes seen in other U.S. treaties), one can reasonably infer that the test is met if the requisite eligible shareholders are found at any level in the chain of ownership of the U.S. company. An eligible person is either a qualifying person under the

¹⁹Comments made at the 2008 IFA meeting.

²⁰*Id.*

treaty (that is, certain U.S. residents) or an eligible third-country shareholder, being a person who is:

- resident in a country with which Canada has a tax treaty, and entitled to full benefits under such third-country treaty;
- entitled under such third-country treaty to a Canadian rate of tax on the relevant item of income as low or lower than the rate the U.S. company is seeking under the Canada-U.S. treaty; and
- someone who, if resident in the United States, would be a qualifying person under the treaty or would (if carrying on in the United States whatever business they carry on in the third country) come within the scope of the ATB exception of the treaty.

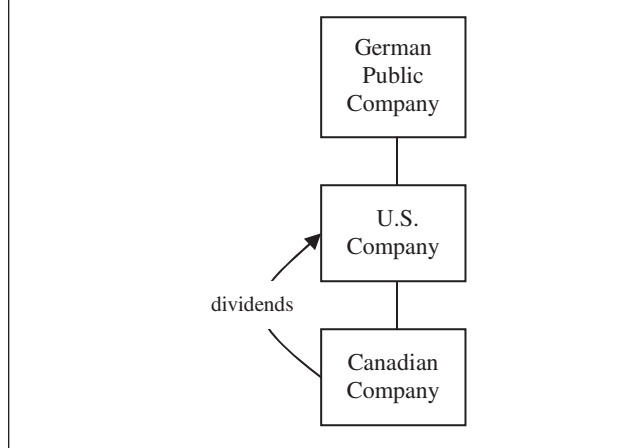
The third element of the test for eligible third-country shareholders is one that may often prove troublesome. In the case of a public company resident in a third country, for example, it could be a qualifying person under the treaty if it were assumed to be a U.S. resident, but only if its principal class of shares was primarily and regularly traded on a recognized stock exchange. The TE states that the public company can meet this test if its shares are so traded on a recognized stock exchange under the treaty or under the treaty between the source country (that is, Canada) and the third country.²¹ However, one problem is that since Canada has no other treaties with LOB articles, it has no other recognized stock exchanges beyond those in the treaty. The result is that unless the third-country public company primarily and regularly trades its principal class of shares on certain Canadian and U.S. exchanges, it will not meet this element of the eligible third-country shareholder test. Take, for example, the case illustrated in Figure 9.

Here, if the German public company's shares trade primarily on a European exchange rather than one in the United States or Canada, it will not meet this element of the qualifying person test in the treaty and U.S. Company will not be entitled to treaty benefits under the derivative benefits rule.

At the June 4 seminar, the question was asked whether stock exchanges that constitute approved stock exchanges under treaties Canada has with other countries will be treated as recognized stock exchanges for this purpose. In the Canada-U.K. treaty, for example, shares quoted on an approved stock exchange are exempted from source-country capital gains tax even if they derive their value primarily from source-country

²¹The text of the Canada-U.S. treaty itself does not mention stock exchanges recognized in the treaty between Canada and the third country, so to this extent the TE appears to be more generous than the treaty itself.

Figure 9. Derivative Benefits Example



real property.²² The answer would appear to be no, although the CRA did state that it may be appropriate to take administrative action to allow derivative benefits to be extended to U.S. Company if it would be eligible for such benefits if the term “recognized stock exchange” included a stock exchange that is both:

- located in a country that has a tax treaty with Canada; and
- a designated stock exchange for purposes of the ITA.²³

Presumably this would be done by the Canadian and U.S. competent authorities so agreeing, as the text of the recognized stock exchange definition in Article XXIX-A(5) of the treaty allows for additional stock exchanges to be recognized by mutual agreement.

The third element of the test for eligible third-country shareholders also has potential issues where the third-country shareholder is not a public corporation. Since only the third-country shareholder itself, not its own shareholders, is treated as if it were a U.S. resident, in many cases it will be very difficult to meet the “qualifying person” test.

Note that the base erosion test in the derivative benefits provision is somewhat onerous relative to many other U.S. treaties. To pass the base erosion test, deductible expenses payable by U.S. Company to persons other than *qualifying persons* cannot exceed 50 percent of U.S. Company's gross income. Expenses payable to persons in countries other than Canada or the United States will therefore always be treated as base-eroding payments. This is less generous than many other U.S.

²²Article 13(5)(a), Canada-U.K. treaty.

²³See *supra* note 7.

treaties.²⁴ As a tax policy matter, one would have thought that expenses payable to persons resident in the relevant third country itself (that is, Germany in the example above), or for that matter any country with which Canada has a tax treaty with a comparable tax rate on the relevant item of income, should not have counted as base-eroding payments. Also, there is no exclusion of arm's-length payments in the ordinary course of business for services or tangible property as base-eroding payments, such as appears in the "qualifying person" test of the U.S. model treaty (which has no derivative benefits exception).

Article XXIX-A(6): Residual Claim

When treaty benefits are not available to a U.S. resident under one of the other elements of the LOB rules, Article XXIX-A(6) requires the Canadian competent authority (upon request from the U.S. resident) to determine whether:²⁵

- (1) the U.S. resident's creation and existence did not have as a principal purpose obtaining treaty benefits that would otherwise not be available; or
- (2) it would not be appropriate to deny treaty benefits to the U.S. resident, having regard to the purpose of Article XXIX-A.

When the Canadian competent authority determines that either (1) or (2) applies, the U.S. taxpayer "shall" be granted treaty benefits. The CRA commented at the June 4 seminar that if numerous requests for relief on the same topic were made, Canadian fiscal authorities could grant relief on an omnibus basis rather than to specific taxpayers only.

The most interesting aspect of Article XXIX-A(6) is the mandatory nature of the provision: The Canadian competent authority "shall" make a determination as to tests (1) and (2), and benefits "shall" be granted when either (1) or (2) are met. The use of mandatory language is a noteworthy departure from the U.S. model treaty²⁶ and other U.S. tax treaties that allow but do not require competent authorities to grant benefits. At the June 4 seminar, the CRA acknowledged that the grant of benefits is mandatory when one of the two tests is met. While this is undoubtedly correct given the wording of the provision, it is interesting that the accompanying TE describes Article XXIX-A(6) as "dis-

cretion[ary]."²⁷ No doubt the competent authority has some scope for judgment in terms of making the determination called for by the provision, but the provision itself does not use the term discretion or any sort of permissive language in describing the competent authority's role, so it would not seem correct to describe the availability of treaty benefits under Article XXIX-A(6) as discretionary. The Canadian competent authority acknowledges the obligation to make a determination upon request, and in Canada decision-making by a governmental authority would typically be subject to some degree of judicial oversight for reasonableness. Moreover, the TE makes clear that once a favorable determination is made benefits should be granted retroactively to the relevant time, so delays in the making of a determination ought not to affect entitlement to treaty benefits.

When a U.S. subsidiary of a third-country multinational is a preexisting and long-standing member of the corporate group with its own substantial activities and assets (that is, clearly not a newly formed entity without an independent purpose), it is not obvious how it would fail to meet test (1) in typical circumstances. Indeed, the fact that there are two separate tests in Article XXIX-A(6), either of which is a sufficient basis for the claiming of treaty benefits and the second of which a residual, judgmental test, supports the view that test (1) should not be interpreted with reference to what tax authorities consider appropriate or inappropriate tax planning. If this is so, then prima facie it would seem that treaty benefits should generally be available for tax planning effected through established U.S. members of multinational groups (that is, those with long-standing independent activities and an ongoing primary purpose other than to facilitate treaty planning into Canada), subject of course to the application of antiabuse rules permitted by Article XXIX-A(7).

In May 2009 the CRA published formal guidelines for requesting the Canadian competent authority to make a determination under Article XXIX-A(6).²⁸ These materials (the "guidelines") include the comment that "it is expected that U.S. resident individuals and virtually all other U.S. residents will not need to make a [request under Article XXIX-A(6)] since they will meet one of the objective tests found in Article XXIX A," which bodes well for the interpretation of those other tests (that is, qualifying person, ATB, and derivative benefits). Also note that an Article XXIX-A(6) request can be made before benefits are denied under some other element of the LOB provisions.

²⁴See, e.g., article 26(3) of the Netherlands-U.S. income tax treaty, in which the test is whether the payment is made to a person that is not an equivalent beneficiary, a term that includes residents of various third countries.

²⁵Based on all factors, including the history, structure, ownership, and operations of the U.S. taxpayer.

²⁶See article 22 of the U.S. model treaty, available at <http://www.treas.gov/press/releases/reports/hp16801.pdf>.

²⁷"[B]enefits may, nevertheless, be granted at the discretion of the competent authority."

²⁸"Guidelines for Taxpayers Requesting Treaty Benefits Pursuant to Paragraph 6 of Article XXIX A of the Canada-U.S. Tax Convention," May 22, 2009, available at <http://www.cra-arc.gc.ca/tx/nrdsnts/rtcl29-eng.html>.

The interrelationship between competent authority applications for benefits under Article XXIX-A(6) and applications to the CRA's Rulings Directorate for advance tax rulings relating to other parts of Article XXIX-A under the existing rulings process is not yet entirely clear. No doubt this will develop over time as actual requests are received from taxpayers. It is understood that in the appropriate circumstances the Canadian competent authority is willing to undertake informal consultations with taxpayers before a formal request for a determination under Article XXIX-A(6) is made.

The process set out in the guidelines for making an Article XXIX-A(6) determination request does not require a fee or any particular form, but an appendix to the guidelines sets out information that the Canadian competent authority requires in order to make a determination. Included in this information is an explanation as to why the taxpayer is not otherwise entitled to treaty benefits under the other provisions of Article XXIX-A (and in particular, a statement as to whether failure to meet a base erosion test is wholly or partly responsible for such ineligibility). The Canadian competent authority will attempt to issue a determination letter with a decision to the applicant within six months of receiving a fully complete request. Determination letters are considered to be binding on the Canadian competent authority, subject to any qualifications included therein and the right to challenge a claim on an antiabuse basis under Article XXIX-A(7).²⁹ Such letters are stated to be effective for three years (or less, if a material change in relevant facts occurs). The three-year period corresponds with the period of time to which the CRA limits advance tax rulings on the application of domestic law. Requests for renewed determinations are stated to require six months' advance notice. Requesting persons are expected to notify the Canadian competent authority of any material changes in facts that might reasonably affect a determination.

New CRA Treaty Benefit Forms

The CRA has recently released new draft forms relating to the claiming of treaty benefits regarding Canadian withholding obligations, for public comment.³⁰ These forms are intended for use whenever a payer of amounts that are potentially subject to Canadian non-resident withholding tax (for example, interest, divi-

dends, or royalties) withholds and remits at a rate less than that called for under domestic law on the basis that the recipient is entitled to a reduced rate of tax under a bilateral tax treaty. While the use of these forms is not mandatory for payers to withhold at a reduced rate,³¹ they offer guidance to payers as to how different provisions of a tax treaty might apply and what kind of diligence the CRA expects payers to undertake before withholding at a reduced rate on the basis of a treaty exemption. Three draft forms are provided:

- NR301, for nonresidents that are neither partnerships nor hybrid entities;
- NR302, for partnerships with nonresident partners; and
- NR303, for hybrid entities such as U.S. LLCs that are disregarded for U.S. tax purposes.

The latter two forms are intended to address the complexities of looking through partnerships and hybrid entities to determine the tax treaty rate that applies.

The new forms are useful in terms of providing a sense of the information the CRA believes is relevant to making a determination of eligibility for treaty benefits, as well as examples of the application of the relevant rules. The example provided in NR303 dealing with hybrids is illustrated in Figure 10. For this purpose a hybrid is defined as a foreign entity (other than a partnership) not entitled to treaty benefits in its own right, but the members/owners of which are entitled to claim treaty benefits through. At present only entities described in Article IV(6) of the treaty would fall into this category.

This example illustrates the manner in which Article IV(6) addresses the problem of Canadian-source income earned through a U.S. LLC, but only for LLC shareholders that are themselves U.S. residents entitled to treaty benefits under the LOB article. In the example in Figure 10, a U.S. LLC (APAN LLC) that is fiscally transparent for U.S. tax purposes earns Canadian-source dividend income from a closely held Canadian corporation. That U.S. LLC in turn has a number of different shareholders:

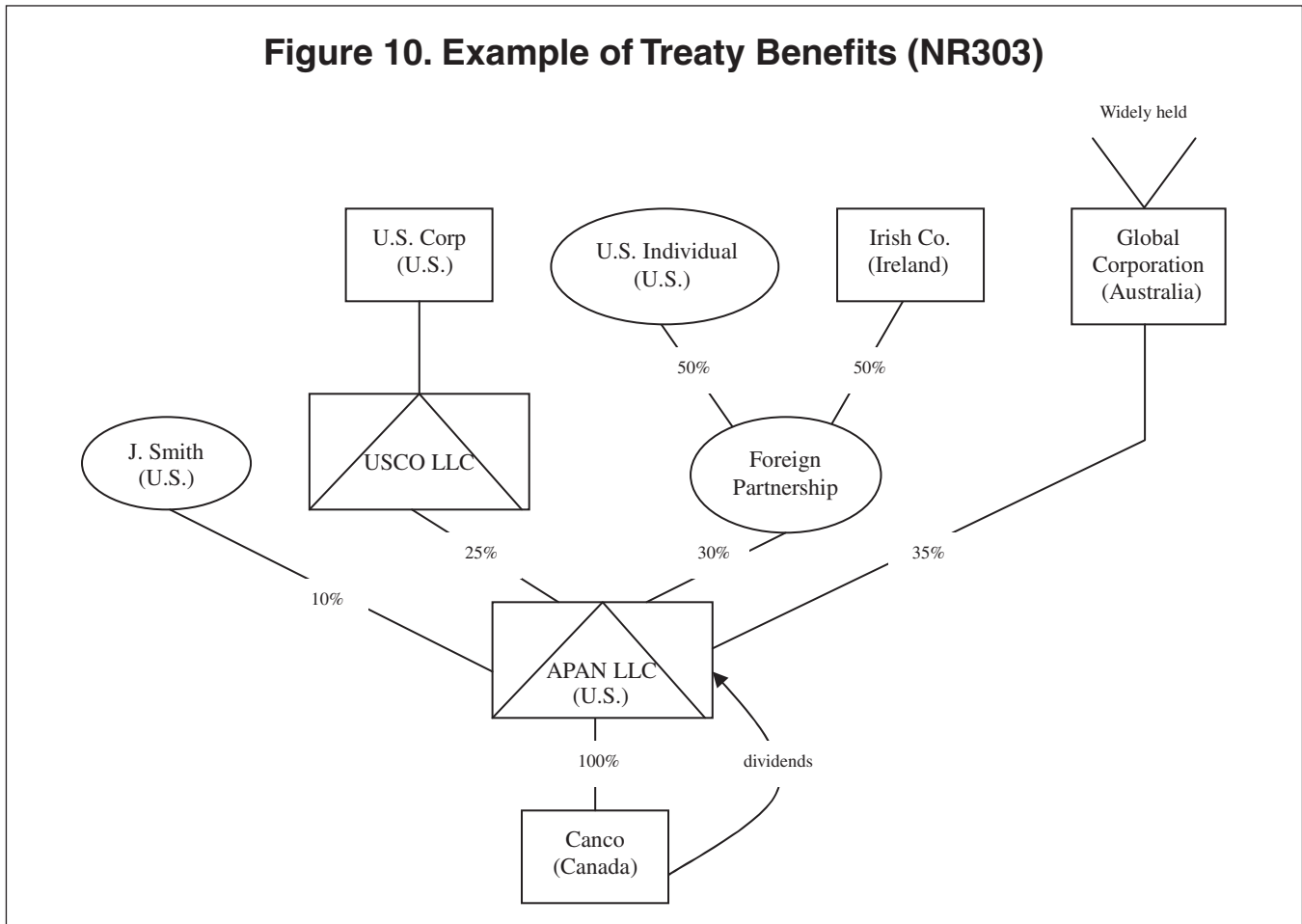
- John Smith (10 percent), a U.S. resident individual;
- USCO LLC (25 percent), another U.S. LLC that is in turn wholly owned by a U.S. corporation resident and liable to tax in the United States;

²⁹It is not clear on what basis a court might find that treaty benefits should be denied as being abusive in the face of the taxpayer either meeting the specific principal purpose test set out in Article XXIX-A(6)(a); or having been determined by the Canadian competent authority to be an appropriate recipient of treaty benefits under Article XXIX-A(6)(b).

³⁰See CRA press release dated June 25, 2009, available at <http://www.cra-arc.gc.ca/formspubs/frms/nr301-2-3-eng.html>.

³¹They would be mandatory for a nonresident seeking a refund of amounts claimed to have been overwithheld.

Figure 10. Example of Treaty Benefits (NR303)



- Foreign Partnership, a partnership (treated as such for U.S. tax purposes) with two equal partners, a U.S. resident individual and an Irish company; and
- Global Corporation (35 percent), a widely held Australian corporation.

Without the benefit of the look-through rule in Article IV(6), the CRA's position would be that Canadian dividend withholding tax would apply at the rate of 25 percent to the dividend received by APAN LLC, on the basis that it would not be a U.S. resident as it is not itself liable to tax in the United States by virtue of being treated as a flow-through for U.S. purposes, and therefore not entitled to any treaty relief. Instead, to the extent that a U.S. resident is considered under U.S. tax law to derive the Canadian dividend income through APAN LLC (and through USCO LLC in the case of its shareholder), under Article IV(6) the dividend income is considered to be derived by that U.S. resident for treaty purposes. Treaty benefits are then applied to APAN LLC accordingly, reducing the rate at which withholding is applied to dividends paid to it. (For Canadian purposes APAN LLC remains the only

visible taxpayer, even though for withholding tax purposes the rate is computed based on who its shareholders are.)

Under the new form NR303, the withholding rate applicable to dividends received by APAN LLC is determined as a composite of the rates applicable to its direct and indirect shareholders, looking through entities that are fiscally transparent for Canadian purposes and in the case of U.S. residents (only) looking through LLCs that are fiscally transparent for U.S. purposes. (See table.)

The analysis behind the computation of this composite rate is as follows:

- J. Smith is entitled to the basic 15 percent treaty dividend rate applicable to U.S. residents (other than corporations owning 10 percent or more of the dividend payer's voting stock).
- USCO LLC is itself a hybrid that is looked through for this purpose; entitled to the 5 percent treaty dividend withholding rate based on the fact that its own shareholder (U.S. Corp) is a corporation indirectly owning more than 10 percent of the dividend payer's voting stock.

Computation of APAN LLC Withholding Rate			
	Indirect Ownership	Look-Through Treaty Rate on Dividends	Proportionate Withholding Rate
J. Smith	10%	15%	1.5%
U.S. Corp (through USCO LLC)	25%	5%	1.25%
U.S. Individual (through Foreign Partnership)	15%	15%	2.25%
Irish Co. (through Foreign Partnership)	15%	25%	3.75%
Global Corporation	35%	25%	8.75%
Total	100%	-	17.5%

- Foreign Partnership is itself looked through for this purpose; U.S. individual partner would be entitled to the 15 percent treaty dividend withholding rate (same as J. Smith), while Irish Co. would not be entitled to any treaty reduction because:
 - Article IV(6) of the treaty only provides relief to the extent of *U.S. residents* earning income through an LLC such as APAN LLC; and
 - nothing in the Canada-Ireland treaty entitles an Irish shareholder of an LLC to treaty benefits on income earned by that LLC.
- Global Corporation is not entitled to any treaty reduction in withholding, because:
 - Article IV(6) of the treaty only provides relief to the extent of *U.S. residents* earning income through an LLC such as APAN LLC; and

— nothing in the Australia-Canada treaty entitles an Australian shareholder of an LLC to treaty benefits on income earned by that LLC.

Conclusion

The new LOB article of the treaty represents a major change in Canadian tax policy with its most important trading partner, the United States. While some sources of Canadian guidance have been developed to date, a number of interpretative issues remain, and the CRA clearly wants to spend more time developing a coherent and consistent approach toward the administration of the LOB article. U.S. taxpayers seeking to obtain treaty benefits on Canadian-source income would be well advised to monitor developments in this area. ◆