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# Strafford US-Canada Cross-border Tax Webinar

October 6, 2010

*5<sup>th</sup> Protocol to the Canada-US Treaty:  
Hybrid Entities, LoB Provisions & 0% Withholding on Interest*

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*Part 1:*  
*Article IV(7): Anti-Hybrid Provision*

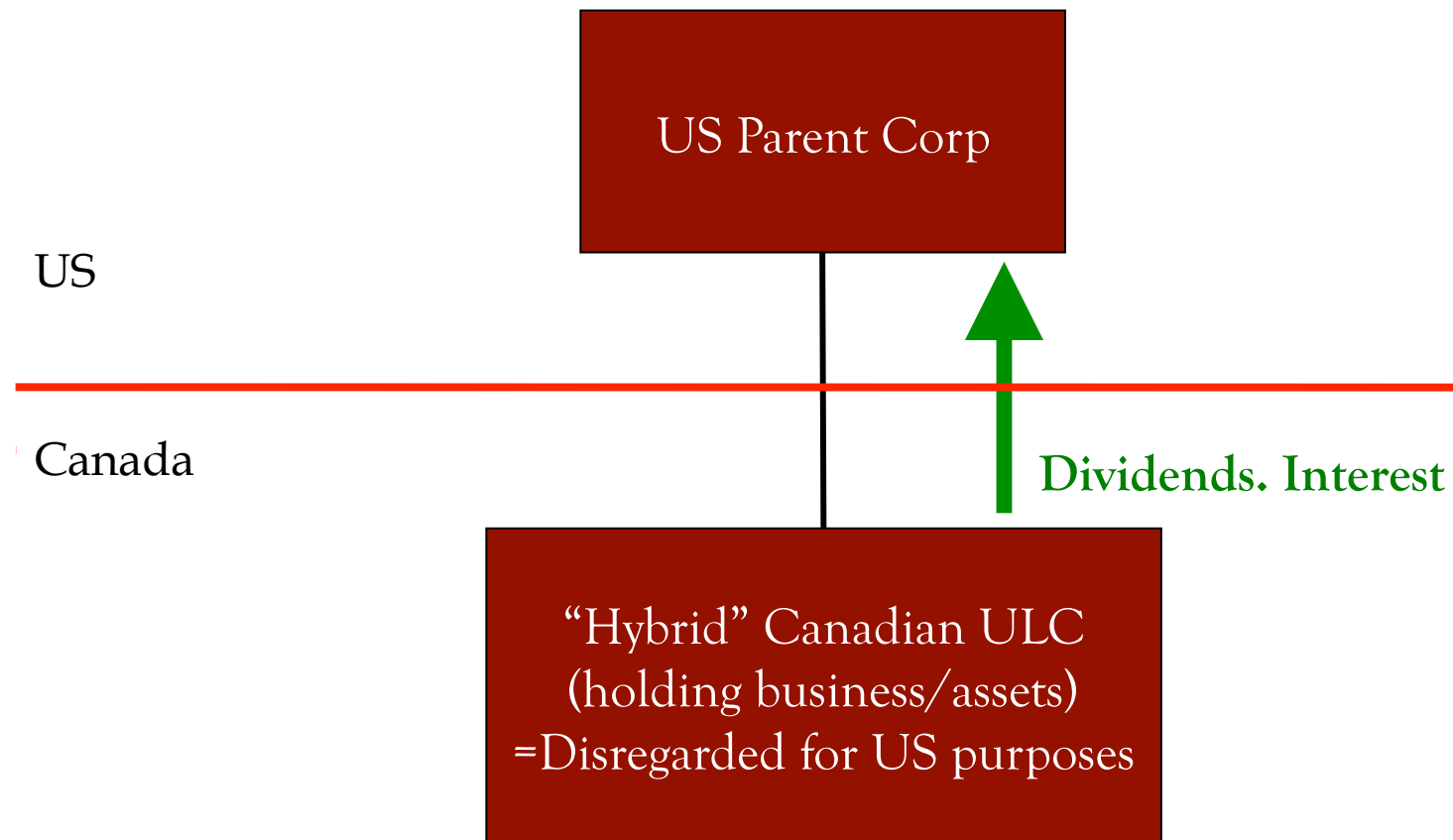
## 5<sup>th</sup> Protocol Anti-Hybrid Provision– Art. IV(7)

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- New Article IV(7) provides that a US resident is NOT given treaty protection for payments or transfers from Canadian residents in two cases:
  - (a) A US resident is considered under the tax laws of Canada to have derived the income *through* an entity not resident in the US, but by reason of the entity not being treated as fiscally transparent in the US, the treatment of the income under the tax law of the US is not the same as it would be had the amount been derived directly from Canada
  - (b) A US resident is considered under the tax laws of Canada to have received the income *from* an entity that is resident of Canada, but, by reason of the entity being treated as fiscally transparent under the laws of the US, the treatment of the income under the tax law of the US is not the same as it would be if the entity were not transparent in the US
  
- Effective Jan. 1, 2010

# Canadian Inbound Structure #1

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## Before 5<sup>th</sup> Protocol

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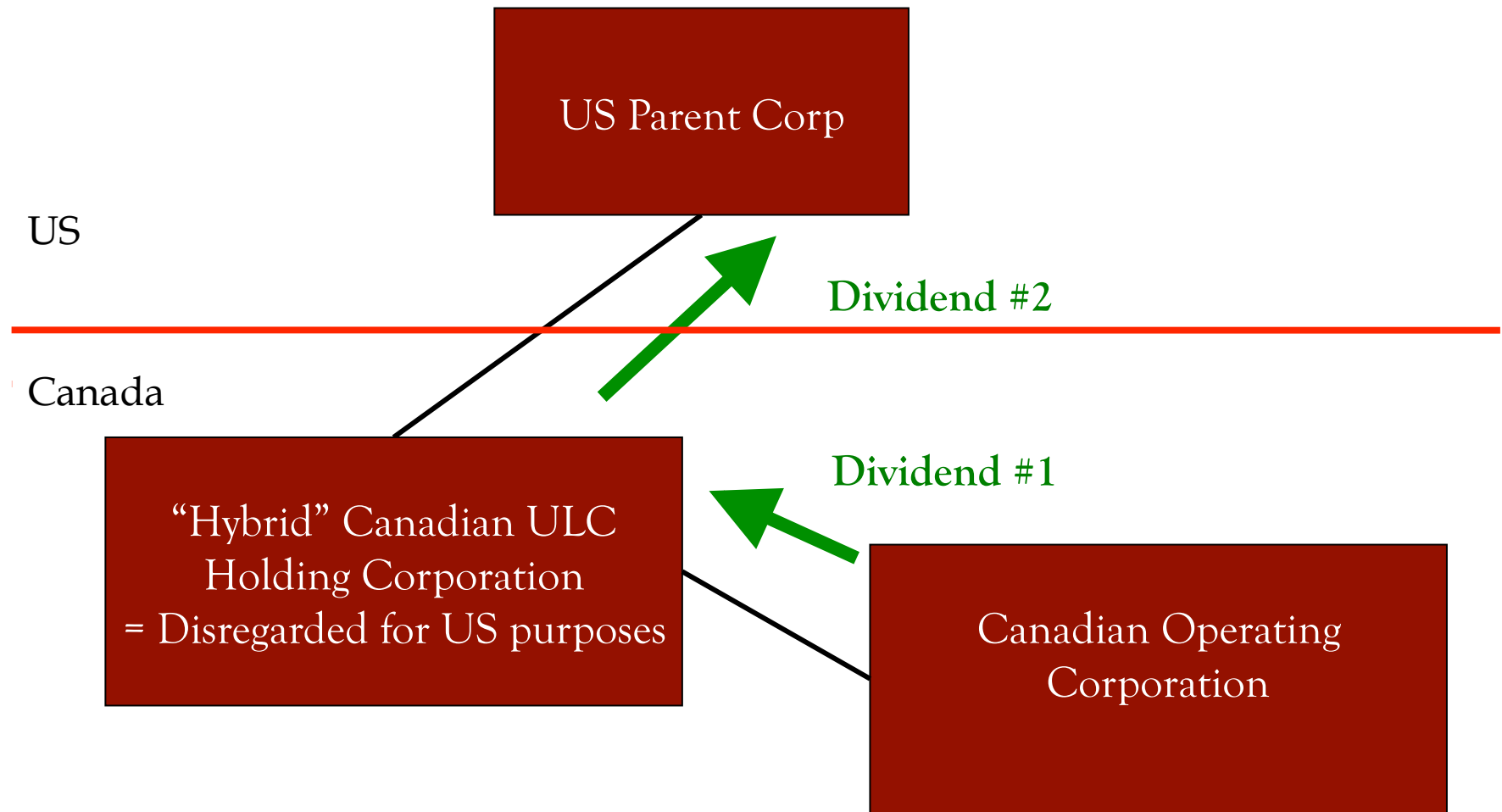
- Typical structure – US ParentCo with OpCo ULC in Canada
- Under Canadian taxation law, US ParentCo receives dividends from a corporation resident in Canada
- Canadian ULC fiscally transparent in the US
- Dividend received full treaty protection, and because USCo owned more than 10% of shares of ULC, withholding rate reduced to 5%
- No “dividend” (income) in the US because ULC and USCo considered to be one entity

## Impact of Art. IV(7) on Structure #1

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- Canadian ULC fiscally transparent under US law so the treatment of the dividends (i.e. non-recognition of income or dividend) is not the same as it would be if the ULC were not treated as fiscally transparent under US law
- Therefore, USCo does not receive benefits of the treaty with respect to the dividends received => Canadian 25% statutory withholding tax on dividend payment

# Canadian Inbound Structure #2



## Impact of Art. IV(7) on Structure #2

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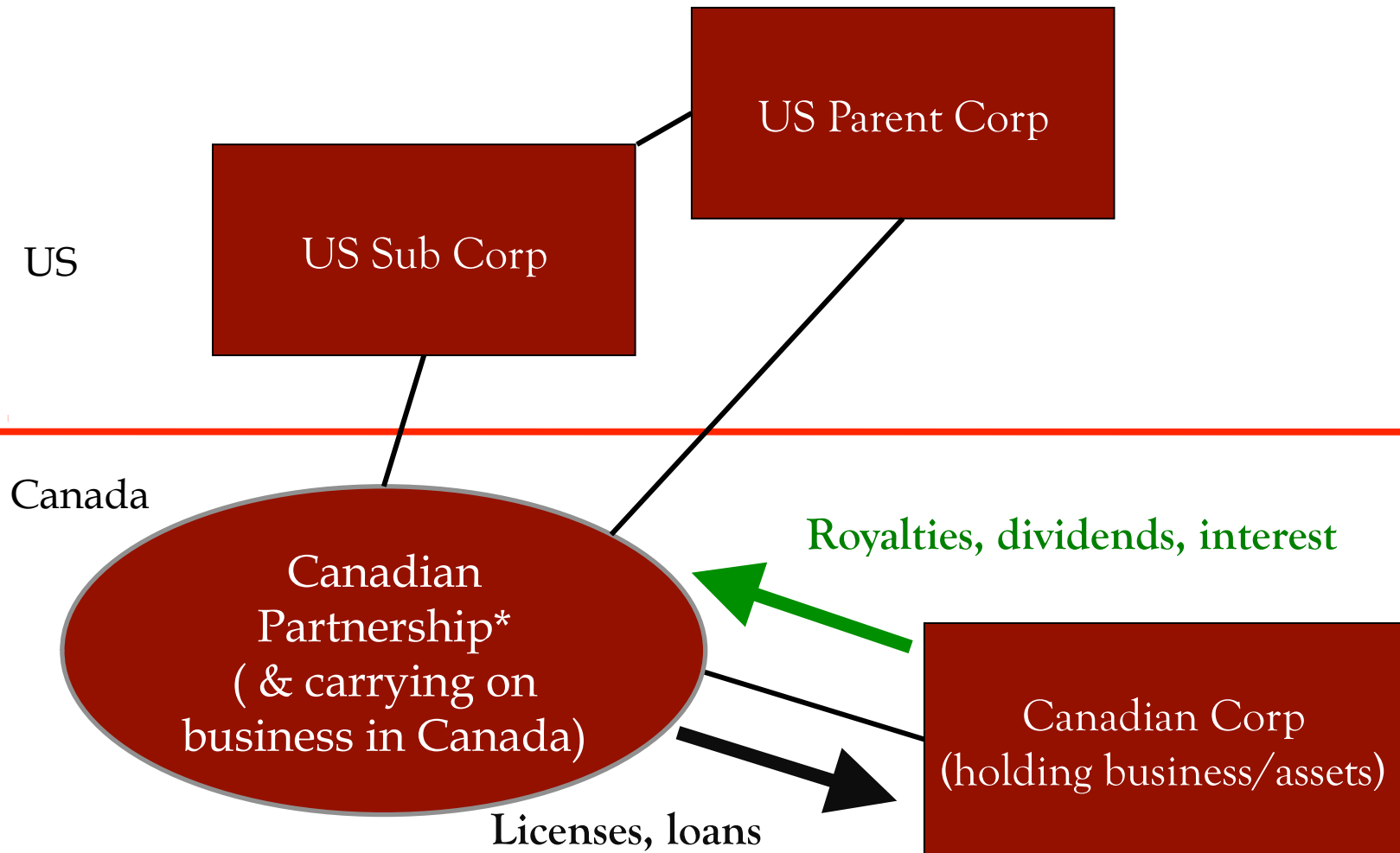
### ■ Back to Back Dividends:

- USParentCo owns Hybrid ULC HoldCo which owns 100% of a Canadian Operating Corporation (CanOpCo)
- On the same day, CanHoldCo pays dividend to Hybrid ULC HoldCo & Hybrid ULC HoldCo pays a dividend to USParentCo of same or similar amount

### ■ From a US perspective, USParentCo has received a dividend from CanOpCo

- ### ■ Although a dividend from Canco would be similar to a dividend from Hybrid ULC, CRA position is that the US tax treatment is different
- “Same Treatment Test” not satisfied, Art, IV(7)(b) applies to the dividend paid by Hybrid ULC to USParentCo = 25% statutory withholding tax

# Canadian Inbound Structure #3



## Before 5<sup>th</sup> Protocol

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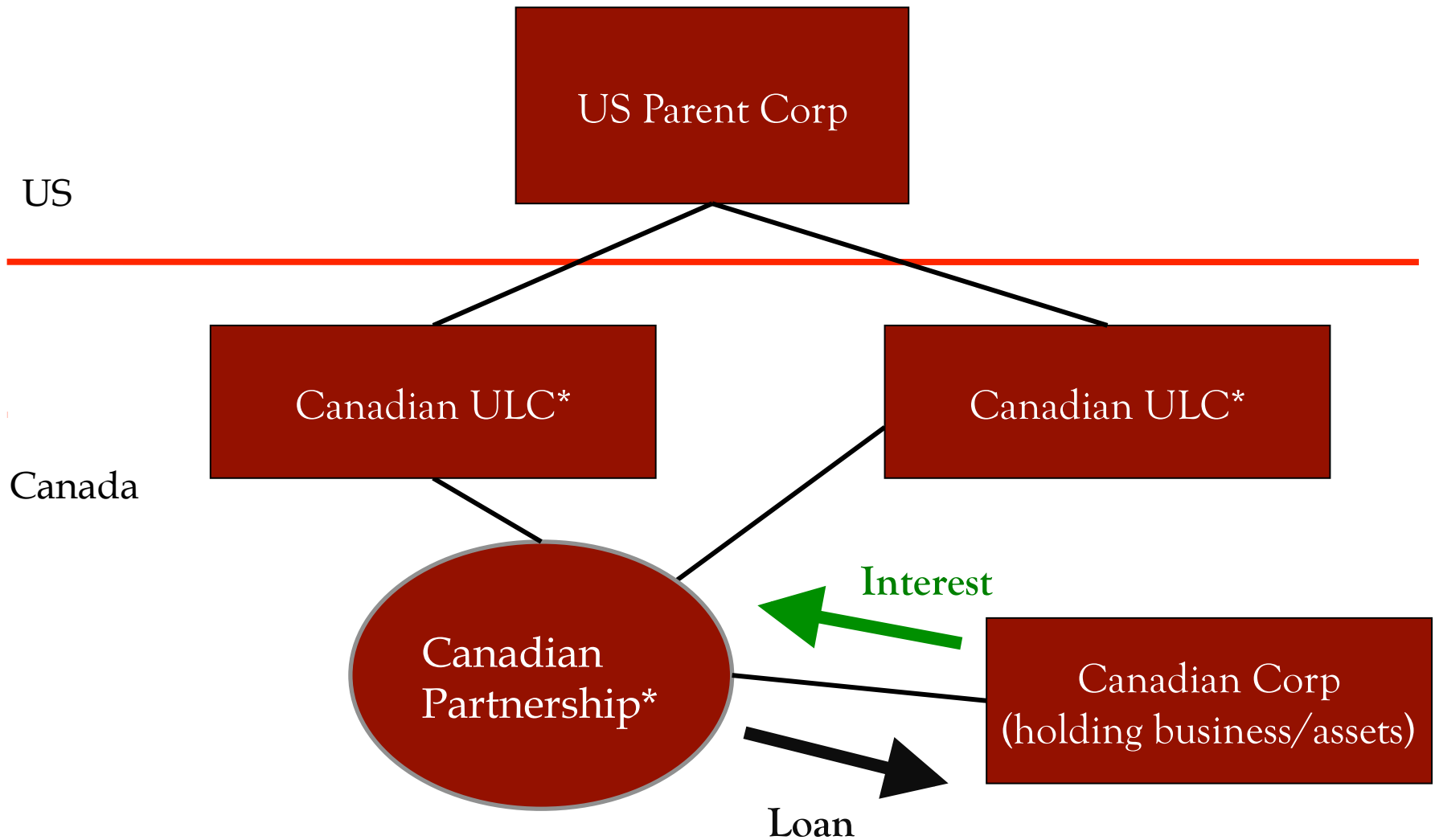
- Canadian partnership treated as corporation for US purposes\*
- Income earned by Canadian partnership generally not taxable in US until cash distributed
- Interest or other expense deduction in Canada, no income inclusion in US
- Income earned by Partnership by “Carrying on Business” also not treaty protected

## Impact of Art. IV(7) on Structure #3

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- USCos considered under laws of Canada to have derived the amount through an entity that is not a resident of the US
- The partnership is not fiscally transparent under U.S. tax law ( check the box so no income recognition until distributed)
- Because the partnership is not treated as fiscally transparent in the U.S., the treatment of amounts distributed by the partnership is not the same as the treatment would be if the amounts had been received directly by US Cos
- Statutory withholding applies on payment of non-arm's length interest payment – very adverse result!

# Canadian Inbound Structure #4



## Impact of Art. IV(7) on Structure #4

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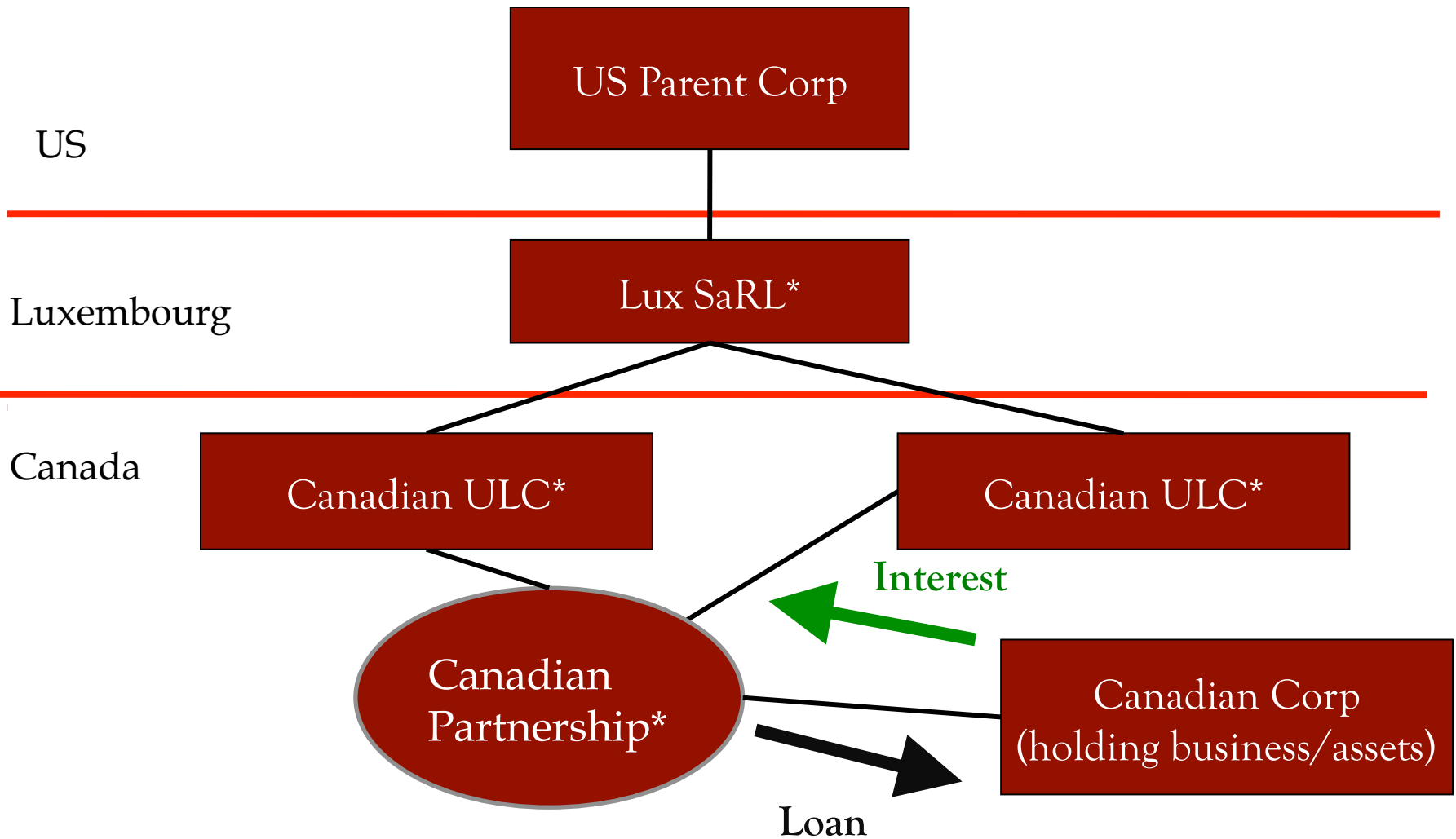
- Same as previous structure, US Parent Co injects the form of equity & loans (Canadian thin cap rules)
- Canadian ULCs and partnership treated as corporations for US purposes\*
- Income earned by Canadian partnership generally not taxable in US until cash distributed
- Interest deduction in Canada, no income inclusion in US
- Art IV(7) would now deny treaty benefits for interest and dividends paid by ULCs

## Examples of Non- Application of Art IV(7)

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- The CRA indicated that Article IV(7) would not apply to deny treaty benefits in the following situations, subject to GAAR :
  - Luxembourg SaRL is inserted between US. shareholder and Hybrid ULC subsidiary
  - Increase and Reduction of Paid-up Capital (PUC) by a Hybrid ULC
  - Interest Payments by Hybrid ULC to US Grandparent
  - Hybrid ULC with More than One Shareholder
  - Sale of Shares of Hybrid ULC to Arm's Length Purchaser
  - Royalty Paid to a Third Party

# CRA Approved Example # 1



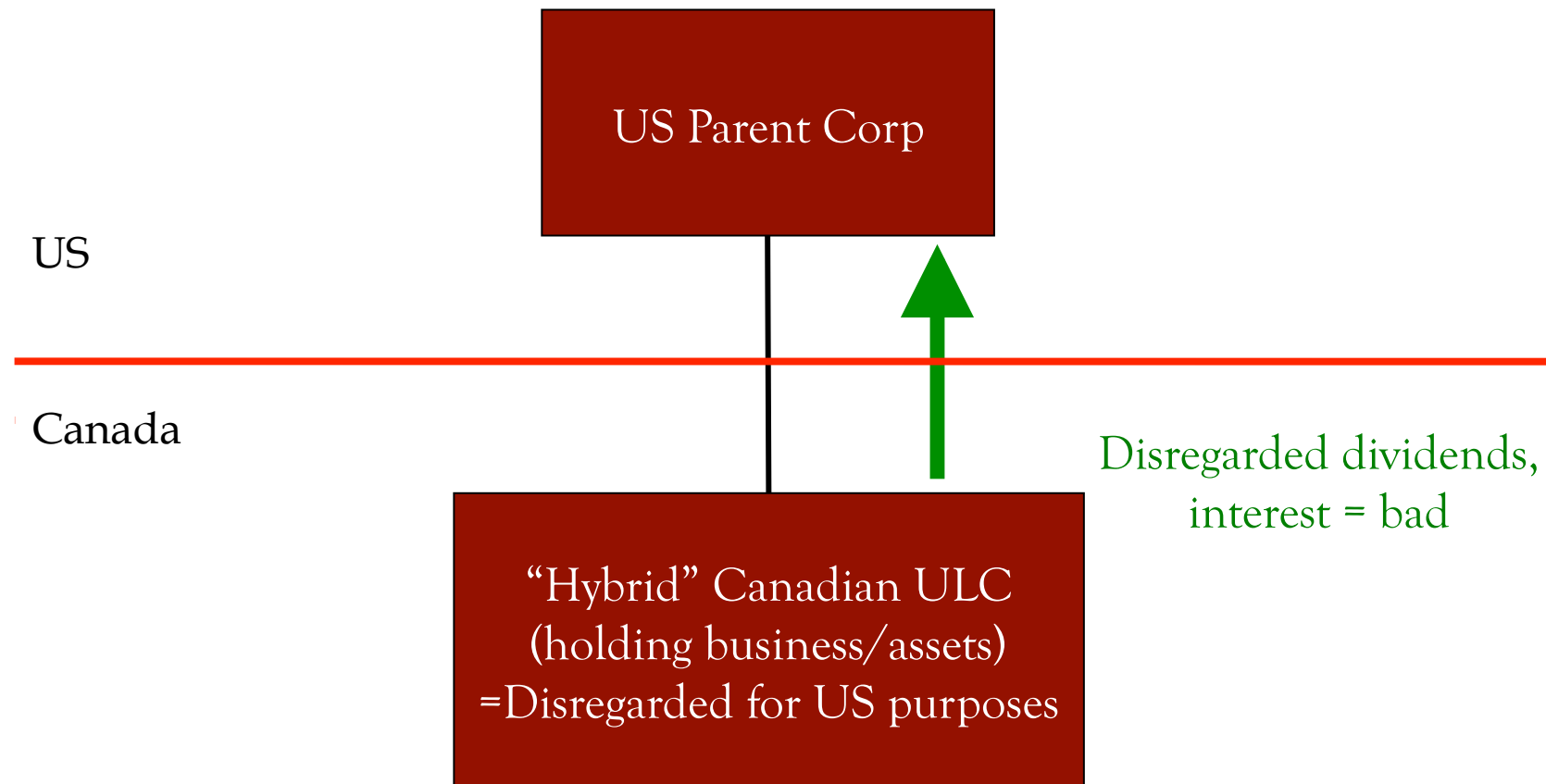
# CRA OK Ex. 1: Third Country Solution

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- US Parent Co injects capital into Lux SaRL in the form of CPECs, which finances the ULCs in the form of equity & loans (Canadian thin cap rules)
- Lux SaRL, ULCs and Canadian partnership treated as corporations for US purposes\*
- Income earned by Canadian partnership generally not taxable in US until cash distributed
- Interest deduction in Canada, no income inclusion in US
- Art IV(7) would not apply, as there is no application of Canada-US treaty to the structure – relies on Can-Lux and US-Lux treaties

# CRA Approved Example #2: Playing with PUC

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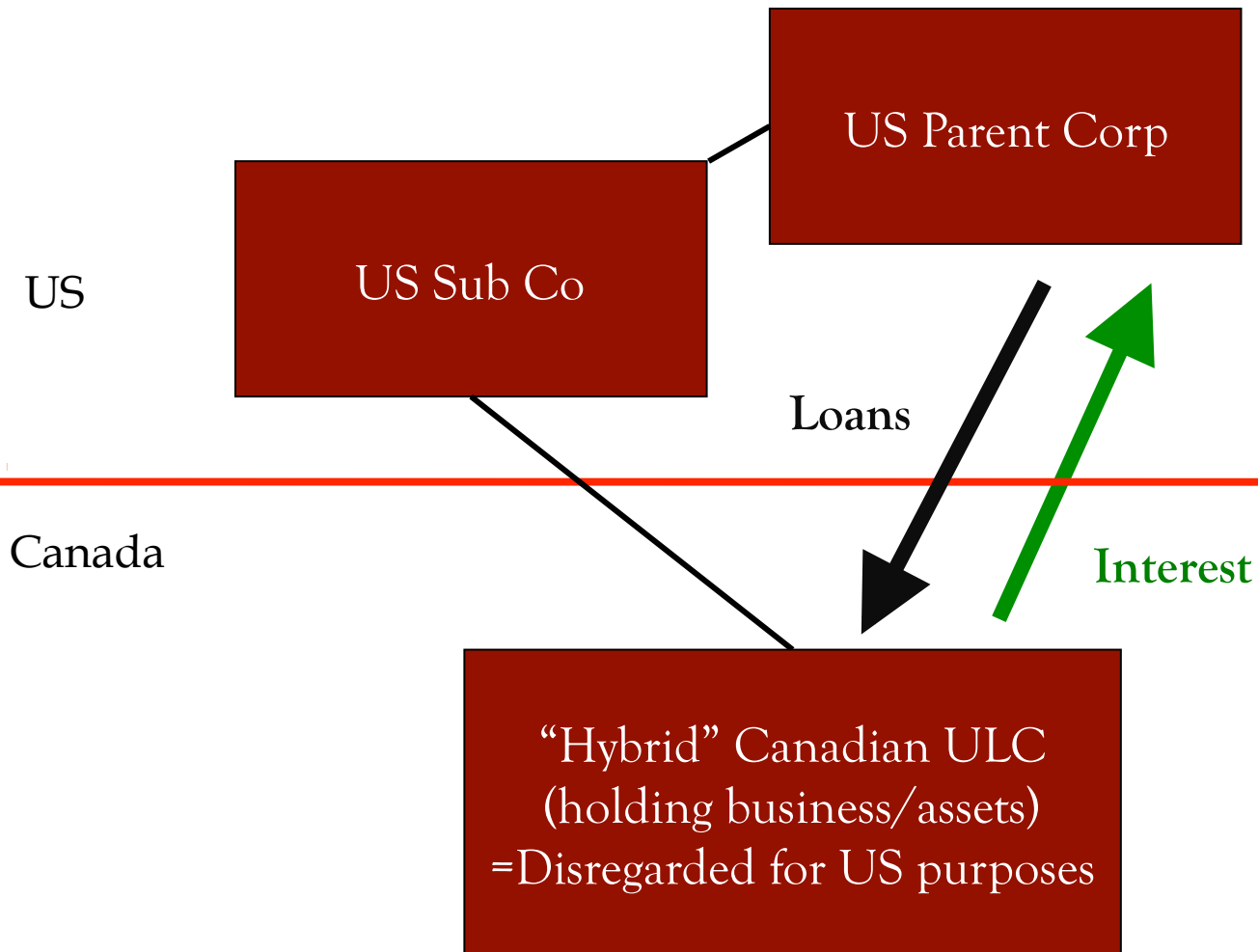


Dividend in Canada but return of capital in US, or capital reduction/deemed dividend in Canada, proceeds of disposition or a return of capital for US tax purposes = OK

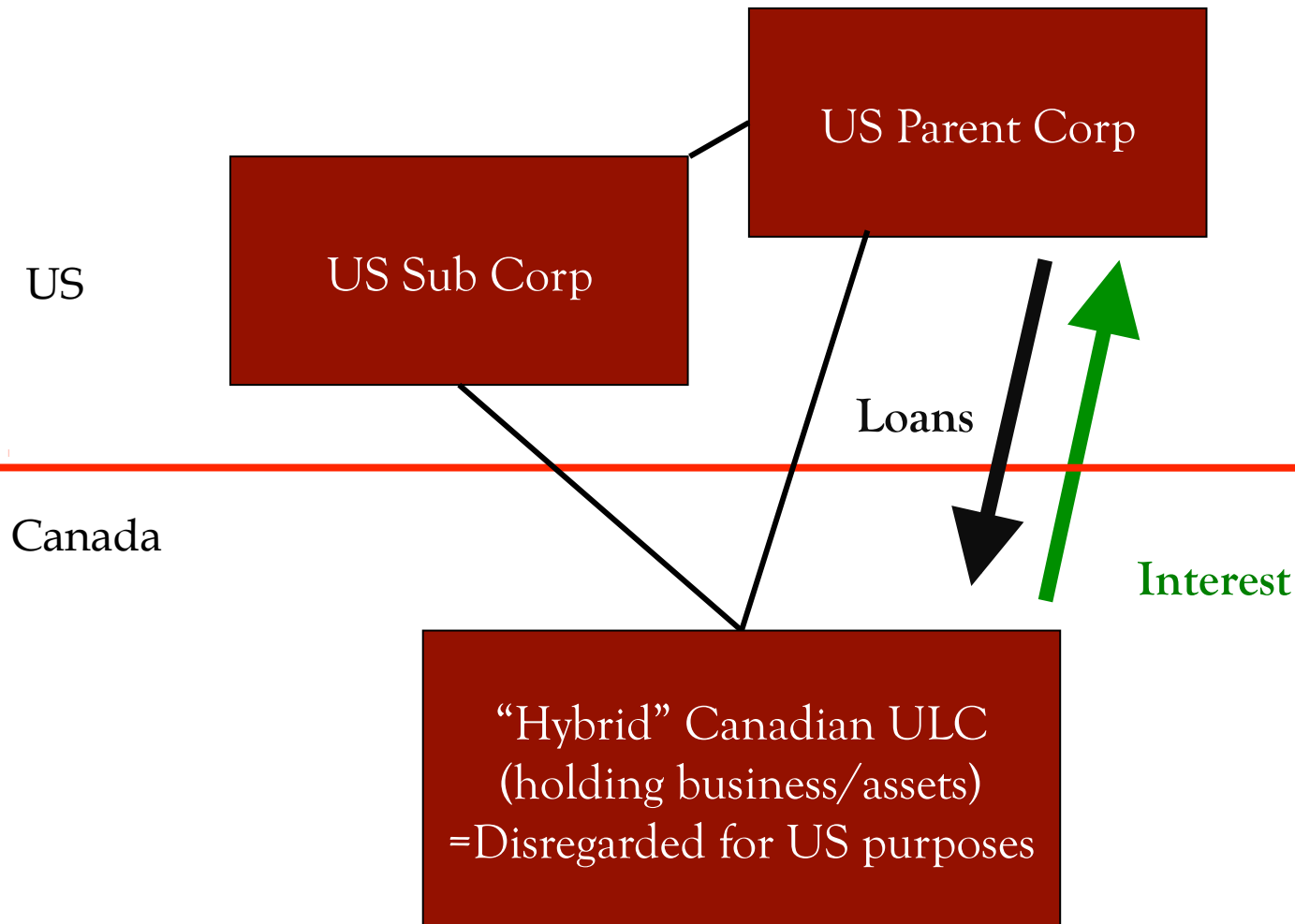
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# CRA Approved Example #3: Grandparent Debt

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# CRA Approved Example #4: 2 Shareholders



# CRA OK Ex. 5: Sale of Hybrid ULC

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## ■ Sale of Shares of Hybrid ULC:

- USParentCo owns 100% of the shares of Hybrid ULC (plain vanilla case)
- USParentCo sells shares of Hybrid ULC to an arm's length purchaser

## ■ Tax Consequences:

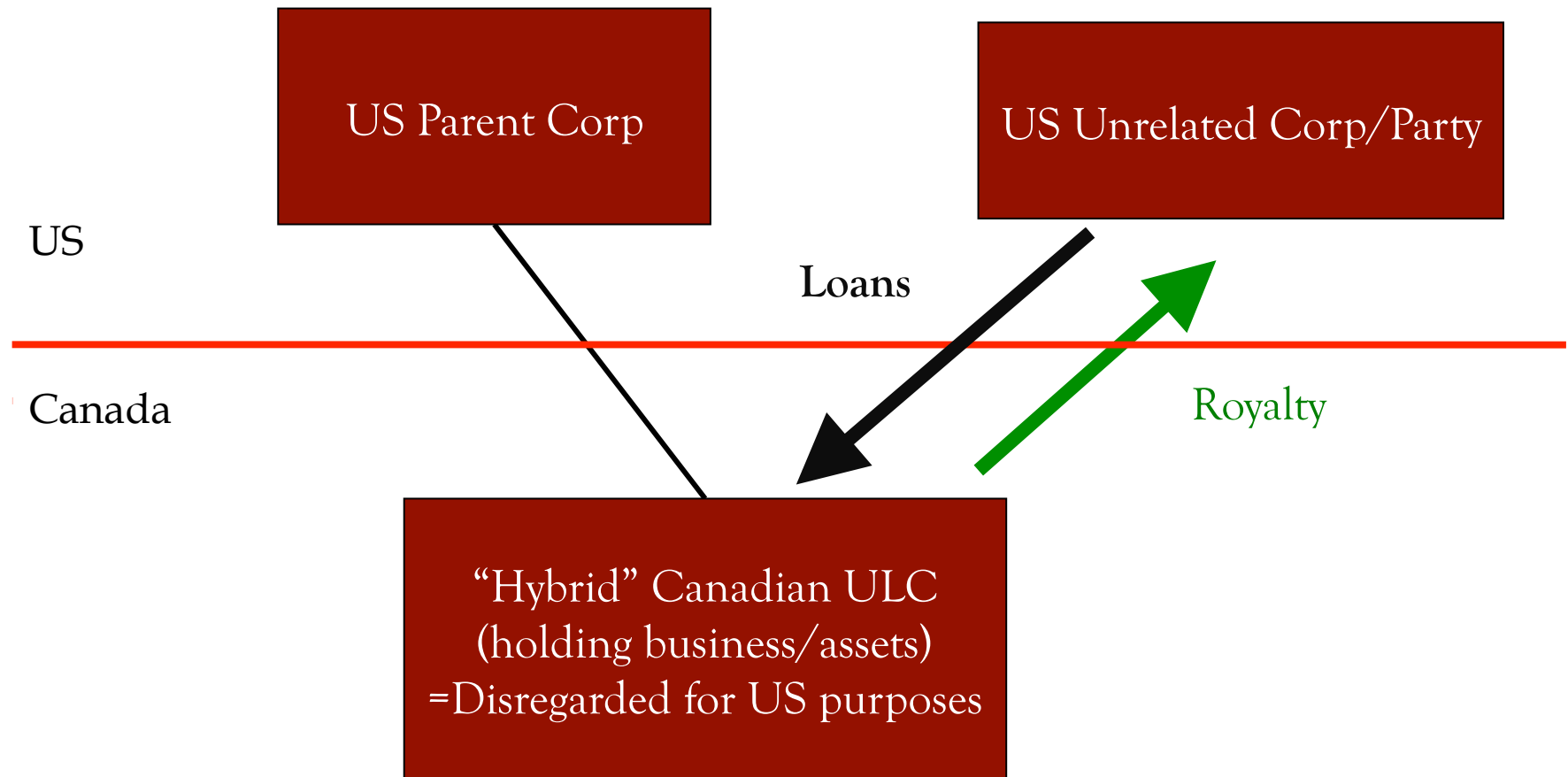
- Canada: USParentCo realizes a capital gain on the sale of shares
- US: USParentCo has sold the assets of Hybrid ULC.

## ■ Art. IV(7)(b) could apply because of differences in character and quantum of the gain derived by USParentCo under US & Can tax law

## ■ CRA Position: Art. IV(7)(b) does not apply to arm's length sale; USParentCo exempt for Canadian capital gains tax under the Treaty

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# CRA Approved Example #6: Third Party Royalties



# CRA OK Ex. 6: Third Party Royalties

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## ■ US ParentCo owns 100% of the shares of a Hybrid ULC

- Hybrid ULC is granted a right to use patent by a Third Party
- Third Party is resident in US under the Treaty
- Hybrid ULC pays royalties for license to Third Party

## ■ Tax Treatment:

- US: Third Party has received royalties from USParentCo
- Canada:, Third Party has received royalties from Hybrid ULC

## ■ CRA Position:

- Same Treatment Test met because the quantum, character and timing of the payment received by Third Party is the same regardless of identity of the payor for U.S. tax purposes

## 5th Protocol & LLCs

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- LLCs - Under the 5<sup>th</sup> protocol, US LLCs now recognized as resident in the US pursuant to Art IV(6)
- *TD Securities* case - TCC ruled LLCs resident in the US without the Treaty, but specifically does not deal with post-5<sup>th</sup> Protocol period
- Still does not solve problems
  - Stacked LLCs - All parties inbetween must be Qualifying Persons - Treaty allows for one look-through, not multiple
  - LLCs also have complicated structures

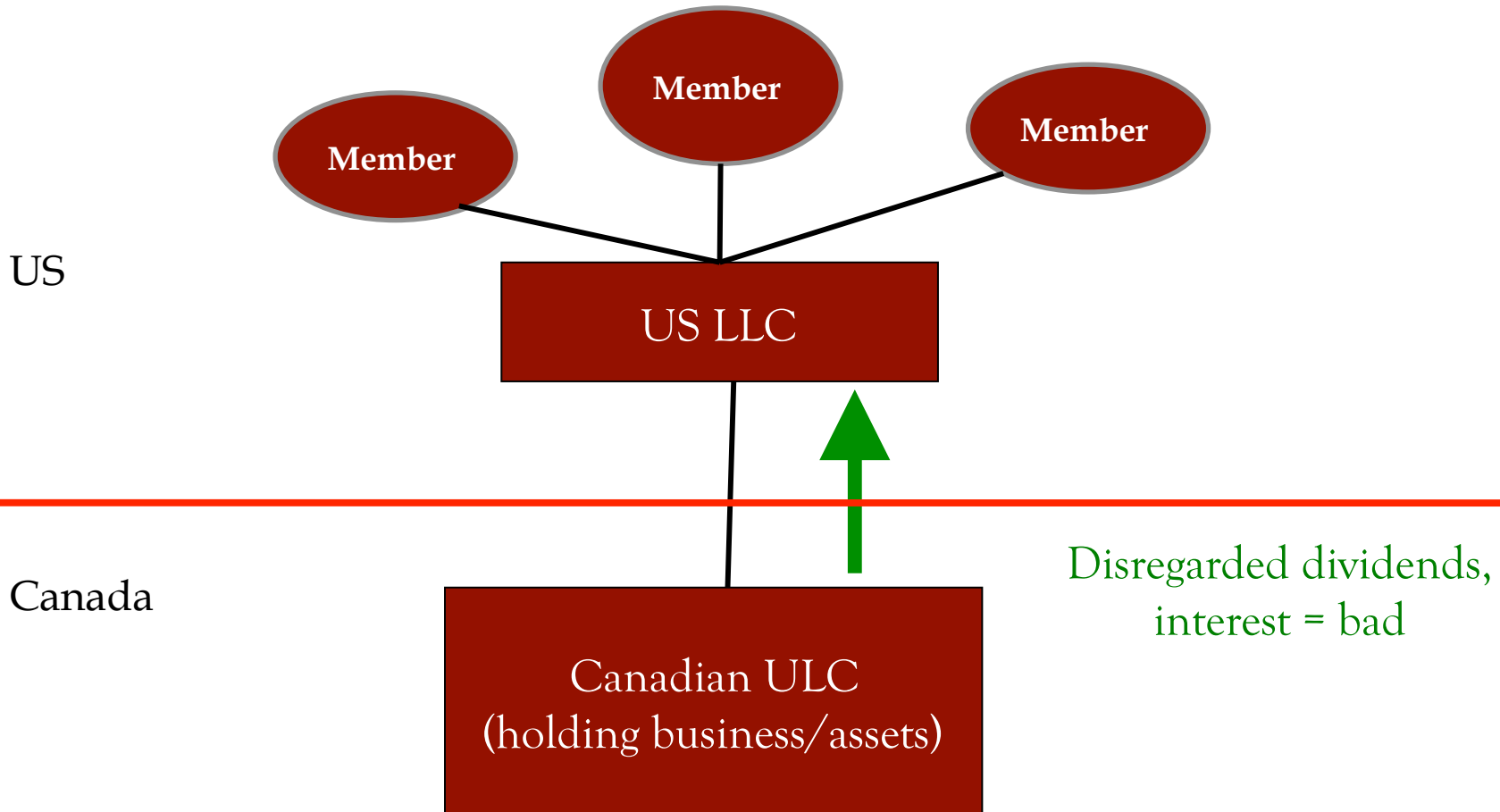
# CRA Positions – Changes & Reassurances

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- February 17<sup>th</sup>, 2010 the CRA released a revised position regarding a fairly common structure – US LLC owning Canadian ULC
- Previously stated that it would accept that the LLC was a look-through under Art. IV(6), and there would be treaty benefits applied to such a structure on payment of dividends
- CRA revised its position – LLC is a pass-through, but the transaction is still subject to the Anti-Hybrid Rules in Art. IV(7)(b), so a dividend would be subject to statutory withholding
- However, CRA subsequently stated it is “willing to consider” treating a dividend being treaty protected if the transaction is not disregarded for US purposes but tax treatment different

# US LLC Parent with OpCo in Canada

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Dividend in Canada but return of capital in US, or capital reduction/deemed dividend in Canada, proceeds of disposition or a return of capital for US tax purposes = OK

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*Part 2:*  
*Article XXIX A – Limitation On Benefits*

# Introduction

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- The new Limitation on Benefits (LoB) provision in Article XXIX A limits to treaty benefits provided by Canada to US residents is now in force
- Prior to the 5<sup>th</sup> Protocol, the LoB previously applied only to benefits granted by the US to Canadian residents in respect of their transactions involving the US tax system
- LoB seeks to prevent “treaty shopping” by residents of third states, requiring that any person or entity seeking benefits under the Treaty not only be a US resident, but also satisfy other tests

## Introduction 2

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- LOB provision needs to be considered any time a US resident claims treaty benefits in respect of payments of dividends, interest or royalties from a Canadian source or on the the disposition of Canadian *situs* assets
- The Technical explanation (“TE”) to the 2007 Protocol issued by the US Treasury Department in December of 2009 provides guidance on interpretation of various articles of the Protocol
  - The Canadian government has stated that it endorses the US government’s interpretation of the TE and will apply the terms of the Treaty in a manner consistent with the

## General rule of application

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- Art. XXIX A (1): In order to be entitled to benefits of the Treaty, a US Resident must:
  - be a “Qualifying Person”, as (defined in Art XXIX A (2)), or
  - Meet the exceptions provided in para. 3, 4 or 6:
    - ◆ Paragraph 3 provides for “Active trade or business” test;
    - ◆ Paragraph 4 provides for “Derivative benefits” test;’
    - ◆ Paragraph 6 allows for “Discretionary determinations”

## Art. XXIX A (2): Qualifying Persons

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- Qualifying Person test applied to person seeking benefit of Treaty
  
- Qualifying Persons include:
  - Natural Persons (par 2(a))
  - Public companies (par. 2(c)) = shares are traded on Canadian or US stock exchange
  - Subsidiaries of public companies (par. 2(d))
  - Entities qualifying under ownership/base erosion test (par. 2 (e))

## Art. XXIX A (2): Qualifying Persons

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- Subsidiaries of public companies (par. 2(d))
  - If more than 50% of votes and value owned by at most 5 corporate shareholders, AND
  - Each intermediate company is a qualifying person
  
- Entities qualifying under ownership/base erosion test (par. 2(e)):
  - If 50% or more of votes and value owned by qualifying persons; and
  - Expenses paid/payable to non-qualified persons is less than 50% of gross income

# Non-Qualifying Persons: Partial Benefits

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- Non-Qualifying Persons can receive treaty benefits on certain specific types of income in specific circumstances
  
- Active trade or business test (par. 3)
  - Carry on active trade or business in US
  - Income derived in Canada is connected with or incidental to US activity
  - US activity is substantial compared to business in Canada
  
- Treaty applies to income derived from such business

# Non-Qualifying Persons: Partial Benefits

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- Derivative Benefits Test (par. 4)
- US Residents will receive treaty protection for payments of interest, dividends and royalties if:
  - More than 90% of votes and value owned by:
    - ◆ Qualifying persons; OR
    - ◆ Persons resident in a treaty country and that treaty tax rate is less than or equal to Canada-US treaty rate
  - Or if expenses paid/payable to non-qualified persons is less than 50% of gross income (Base Erosion Test, same as in subpara. 2(e))

## Art XXIX(7): Domestic Anti-Avoidance Rules

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- Preserves right of domestic tax jurisdiction to apply its own anti-avoidance rules to deny treaty benefits in the presence of abuse
- Such domestic anti-abuse provisions apply in conjunction with explicit anti-treaty shopping provisions of LOB
- Canadian domestic anti-abuse provision is the General Anti-Abuse Rule or “GAAR” in s. 245 of the Act

# Working with Anti-Hybrid & LoB Provisions

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- Key issue is to understand “the Mischief” – provisions were enacted to prevent double dips and arbitrage between tax systems where amounts are treated differently in each country to the advantage of taxpayer
- Anti-hybrid provisions seem to have been thrown together at the last minute, same as LoB provisions, in response to tax court losses
- Provisions are too broad, and in some ways half-baked, and the CRA knows it
- Therefore the CRA has been making positive comments regarding various work-arounds, but always holding out the possibility of a GAAR argument (i.e. applying XXIX(7))

# Working with LoB and AH Provisions

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- The comments received since the last Tax Seminar have generally been approving of various work-arounds, but CRA has reserved the right to apply GAAR
- However, the issue is “GAARing the Mischief”
- Canadian GAAR applies to treaties according to Canadian law, but the CRA has not had success applying it because of a lack of “misuse or abuse” - treaties are negotiated and are what they are – WYSIWYG
- The CRA/Finance/Justice are trying to create “principles”, starting with the Canada-US Treaty: 1) no double dips; 2) no miss-match arbitrage; and 3) and that “no double taxation” does not mean no taxation

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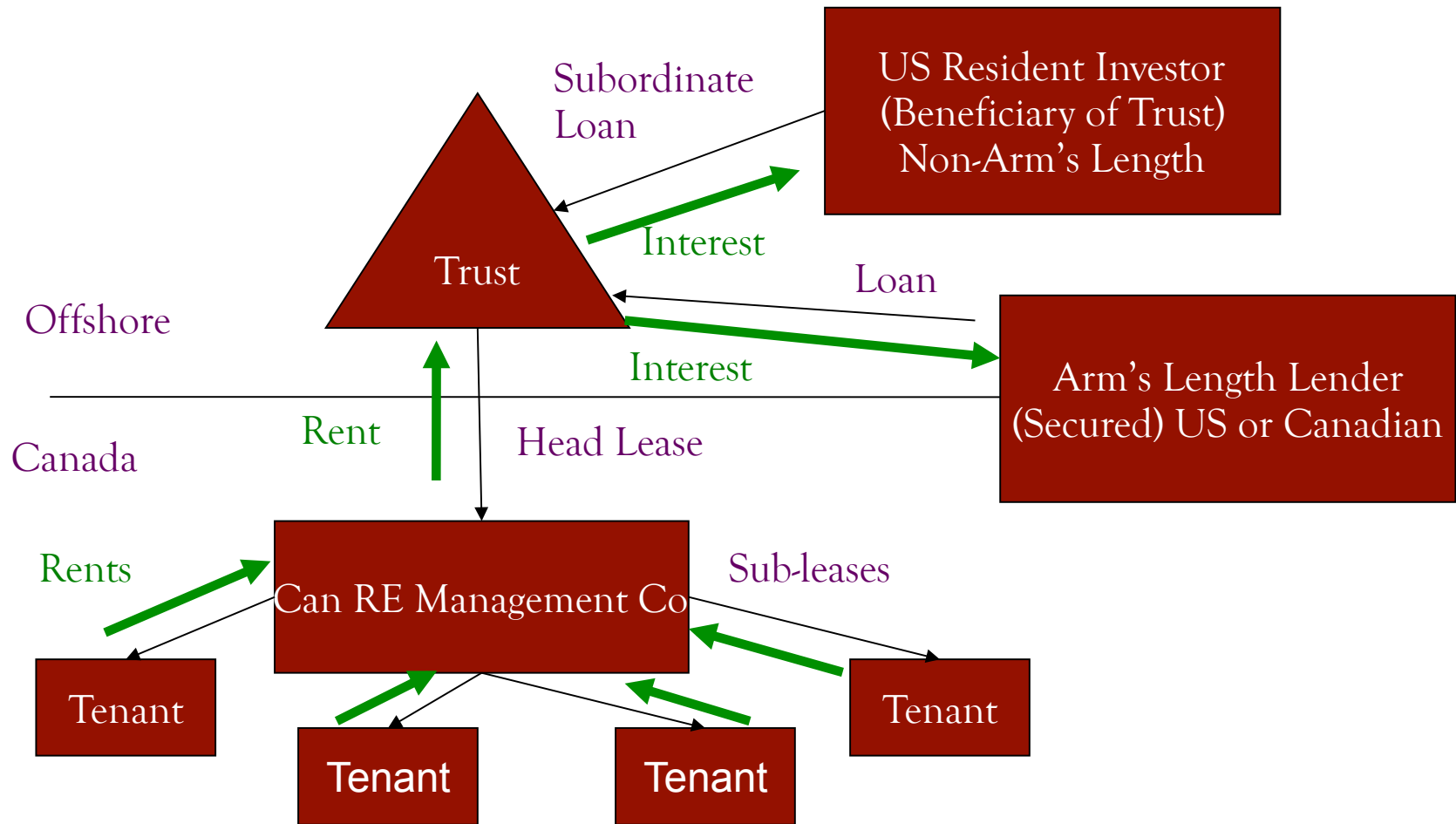
*Part 3:*  
*Article XI: 0% Withholding on Interest*

## Article XI – 0% Withholding on Interest

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- Changes to Treaty pursuant to 5th Protocol significantly increase the tax efficiency of lending into Canada for US resident entities with Canadian subsidiaries and operations
- Withholding rate applied to “non-participating interest” paid by Canadian residents to US residents that are not at arm’s length will be 0% for 2010 onward
- Deductibility of non-arm’s length interest payments still subject to Canadian thin-capitalization rules; interest on debt in excess of 2 times the equity in the Canadian entity is not deductible
- Provided you do not have a LoB or AH problem, if your CanSubs are not loaded up with intra-group debt, they should be

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# Contact Information

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