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International Tax Aspects of Cross Border Business of Closely Held Businesses in Canada

American Bar Association, Section of Taxation
Corporate Committee
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Session Objectives

1. Canadian international taxation – overview
   a) The basics
   b) Liability for Canadian tax
   c) Acquisition, financing, and repatriation

2. Canada-US Tax Convention: Fifth Protocol - selected issues
   a) Background
   b) Article IV (Residence), paragraphs 6 and 7(a)/(b)
   c) Article V (Permanent Establishment), paragraph 9 – Services PE
   d) Article XXIX-A (Limitation of Benefits)

3. Questions/comments

Canadian International Taxation – Overview

The Basics

Overview: The Basics

Canada – background:

– 10 provinces: British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, Quebec, New Brunswick, Nova Scotia, Prince Edward Island, Newfoundland and Labrador

– 3 territories: Yukon; Northwest Territories, Nunavut

Overview: The Basics

Canada – background:

– Corporate income tax based on combined rates = Federal + Provincial

– Declining corporate income tax rates, for example, enacted rates include:

	Federal	Ontario	Combined
• 2010:	18.00%	13.00%	30.00%
• 2011:	16.50%	11.75%	28.25%
• 2012:	15.00%	11.25%	26.25%
• 2013:	15.00%	10.50%	25.50%

Canadian International Taxation – Overview

Liability for Canadian Tax

Overview: Liability for Canadian Tax

- Canadian income tax, where a non-resident person:
  - Carried on a business in Canada
  - Was employed in Canada
  - Disposed of a taxable Canadian property

- Canadian non-resident withholding tax, where a non-resident person:
  - Received certain Canadian source payments – i.e., dividends, interest, royalties, etc.

- Other indirect taxes, where a non-resident person:
  - Incurred federal goods and services taxes, harmonized sales taxes, provincial retail sales taxes, customs and duties, etc.

Overview: Liability for Canadian Tax

- Canadian income tax – where a non-resident person carried on a business in Canada:

  – "Carrying on a business" based on:
    - Common law tests
      – See *Cutlers Guild Ltd.*, *Geigy* and *Gurd's Product Co.*
    - Extended domestic law definition of "carrying on business"
      – See *Maya Forestales S.A*. and *Sudden Valley Inc*.
    - Potential treaty relief if the non-resident is not carrying on business through a permanent establishment situated in Canada
      – See *Fowler* and *Knights of Columbus*

Overview: Liability for Canadian Tax

- Canadian income tax – where a non-resident person <u>was employed in Canada:</u>

- Employment may include:
  - As an employee of a Canadian corporation or other entity;
  - As an employee of a Canadian branch of a non-resident corporation; or
  - In respect of services exercised in Canada while employed by non-resident corporation or other entity
- Potential implications for the employer:
  - Canadian withholding and remittance requirements
  - Human resources/employee management issues
  - Canadian permanent establishment issues

- Potential implications for the employee:
  - Canadian personal tax return filing requirements
  - Double payroll withholdings, foreign tax credit and personal cash flow issues
  - Regulation 102 Waiver may be available

Overview: Liability for Canadian Tax

- Canadian income tax – where a non-resident person has disposed of a taxable Canadian property:
  - Taxable Canadian property – defined term
  - Historically a non-resident vendor was required to:
    - Apply for a Section 116 Clearance Certificate
    - Apply for a Canadian business number
    - File a Canadian tax return
  - Common concerns included:
    - Cumbersome (e.g., private equity partnerships)
    - Canada Revenue Agency clearance certificate issuance delays
    - Purchaser withholding/remittance within 30 days after month of transaction
    - Penalties

Overview: Liability for Canadian Tax

Previous Section 116 amendments (effective 2009) included:

- Related party transaction notification
- Treaty exempt property: no certificate required
- Purchaser's reasonable enquiry re treaty residence

2010 Budget amendments to narrow the definition of taxable Canadian property after March 4, 2010 to include**:**

- Unlisted shares, partnership interests, capital trust/unit trust interests
  - if during preceding 60 months >50% FMV attributable to Canadian real/immovable/resource property and options therein
- Listed shares if during preceding 60 months ≥ 25% of any class owned by taxpayer/related persons AND >50% FMV as above

Overview: Liability for Canadian Tax

2010 Federal Budget: Amendments to Non-resident reporting – i.e., taxable Canadian property cont'd:

- Deemed TCP status on rollovers (e.g. sections 51, 85, 85.1, 87 of the Income Tax Act *(Canada)*) now limited to 60 months thereafter – factual status may extend
- Impact
  - Reduced compliance
  - Funds flow less restricted
  - Ownership/valuation data remains central

Overview: Liability for Canadian Tax

- Canadian non-resident withholding tax on Canadian sourced payments:

– Recipient/payer obligations:
  - Non-resident recipient person – has the liability to the tax
  - Canadian resident payer – obligation to withhold and remit the tax

– Applicable withholding tax rates:
  - Canadian domestic non-resident withholding rate – 25%
  - Rate reduced to 0% on interest (excluding participating debt interest) paid to arm's length non-residents
  - Rates also reduced under the Canada-US Tax Convention; subject to the limitation of benefits article:
  - Dividends – 5%/15%
  - Interest – 0%
  - Royalties – 0%/10%

Overview: Liability for Canadian Tax

- Withholding requirements - for <u>services rendered in Canada</u>
  - Federal - Regulation 105 of the *Income Tax Act* (Canada):

    "<u>Every person</u> paying a non-resident person a fee, commission or other amount in respect of services rendered in Canada, of any nature whatever, shall deduct or withhold 15% of such payment"

  - Key points:

    - "Every person" – includes both a Canadian resident person and a non-resident person; watch for payments to subcontractors and multiple levels of withholdings
    - Withholdings serve as a tax installment
    - Non-resident files Canadian tax return to pay final tax, or claim a refund under treaty
    - Waiver applications permitted; criteria hard to meet
    - Separate Quebec level of withholdings at 9% for services rendered in that province
    - If non-resident to provide services inside and outside of Canada, consider utilizing separate agreements

Overview: Liability for Canadian Tax

- Other Canadian taxes:
  - Indirect taxes:
    - Goods and services tax (“GST”)/harmonized sales tax (“HST”) – i.e., VAT style
    - Based on separate carrying on business criteria; no treaty permanent establishment exceptions
      - “carrying on business” for income tax purposes not identical to “carrying on business” for GST/HST purposes
    - Other provincial equivalent retail sales tax
      - Each province has its own test to determine whether carrying on business in the province and therefore required to register (i.e., Quebec, Manitoba)
    - Customs and duties
      - Consider NAFTA

Canadian International Taxation – Overview

Acquisition, Financing, and Repatriation

Overview: Acquisition

- Acquisition – an overview:
  - “Control” based on a worldwide concept
  - So in Canada or elsewhere up above in the ownership chain
  - If an acquisition of control, then:
    - Deemed tax year-end immediately before
    - Canadian tax compliance requirements
    - Deemed recognition of certain tax losses
    - Restrictions on the ability to carryover pre acquisition of control losses to post acquisition taxation years

Overview: Acquisition

- Acquisition – an overview:
  - Use of a new Canadian acquisition company facilitates:
    - Debt/equity for thin capitalization purposes
    - Establishment of equity (i.e., tax paid-up capital) for future repatriation
    - Future combination of the acquisition and target companies to “push down” acquisition interest expense
    - Potential “bump” (i.e., step up) in the tax basis of certain non-depreciable capital assets owned by the target company

Overview: Financing

- Financing – an overview:
  - Interest expense deductible if incurred for a qualifying purpose
  - Qualifying purpose based on:
    - Statutory domestic law provisions
    - Common law
    - Canada Revenue Agency administrative positions
  - Canada does not currently allow consolidated tax returns; however, 2010 Federal Budget raised potential future consideration
  - Thin capitalization restrictions
    - 2 to 1 debt/equity ratio requirement
    - Disallowed interest – permanent disallowance/retains character as interest so potential for withholding tax to continue to apply

Overview: Repatriation

- Repatriation – an overview:
  - Canada permits repatriation to occur as return of tax paid-up capital or a taxable dividend
  - Foreign country treatment to be considered
  - Return of tax paid-up capital
    - Not subject to Canadian non-resident withholding tax
    - Reduction of shareholder's adjusted cost base in shares
  - Taxable dividend subject to Canadian non-resident withholding tax
    - As noted, Canadian domestic non-resident withholding rate - 25%
    - Reduced to 5%/15% under the Canada-US Tax Convention

Canada–U.S. Tax Convention Fifth Protocol –

Background

Canada - US Tax Convention: Fifth Protocol - Background

- Inbound into Canada – choice generally includes:
  - U.S. subchapter C corporation;
  - U.S. subchapter S corporation;
  - U.S. limited liability company;
  - U.S. partnerships; and
  - Canadian branch or subsidiary operations, of the same including - unlimited liability companies (“ULCs”)

Canada – US Tax Convention: Fifth Protocol - Background

- Effective dates:
  - Canada-U.S. Tax Convention Fifth Protocol signed on September 21, 2007
  - Entered into force December 15, 2008
  - General effective dates:
    - February 1, 2009 for withholding taxes
      - Withholding tax reductions on interest payments were retroactive to January 1, 2008
  - Tax years beginning after December 31, 2008 for all other taxes
  - Special effective dates
    - January 1, 2010 for protocol changes that affect income earned through certain hybrid entities
    - Deemed PE for services provision is effective later of 2010 and 3rd year ending after the December 15, 2008 entry into force date
      - No presence, services rendered, or gross business income received prior to January 1, 2010 will be included in PE determination

Canada – US Tax Convention: Fifth Protocol - Background

- Summary of key provisions:
  - Eliminates WHT on interest to unrelated persons
    - Note - Canadian domestic law already reduces WHT to 0% on interest (excluding participating debt) paid to arm's length non-residents
  - Phases out WHT on interest to related persons
    - 10% (2007)
    - 7% (2008)
    - 4% (2009)
    - 0% (2010 – onward)
  - Treaty benefits for physically transparent entities ("FTEs") like LLCs
  - Loss of treaty benefits for certain hybrid financing structures
  - Loss of "uncertain" treaty benefits for ULC (e.g., unlimited liability companies formed under Nova Scotia, Alberta and British Columbia law) operating and holding companies

Canada–U.S. Tax Convention Fifth Protocol –

Article IV, Paragraphs 6, 7(a)/(b)

Residence

Canada – US Tax Convention: Article IV (Residence)

Art IV(6)	An amount of income, profit, or gain shall be considered to be derived by a person who is a resident of a Contracting State where: (a) The person is considered under the taxation law of that State to have derived the amount through an entity (other than an entity that is a resident of the other Contracting State); and (b) By reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is the same as its treatment would be if that amount had been derived directly by that person.
Art IV(7)	An amount of income, profit, or gain shall be considered not to be paid to or derived by a person who is a resident of a Contracting State where: (a) The person is considered under the taxation law of the other Contracting State to have derived the amount through an entity that is not a resident of the first-mentioned State, but by reason of the entity not being treated as fiscally transparent under the laws of that State, the treatment of the amount under the taxation law of that State is not the same as its treatment would be if that amount had been derived directly by that person; or (b) The person is considered under the taxation law of the other Contracting State to have received the amount from an entity that is a resident of that other State, but by reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is not the same as its treatment would be if that entity were not treated as fiscally transparent under the laws of that State.

Canada – US Tax Convention: Article IV (Residence)

- Background:
  - Canada does not have an entity that is equivalent to an LLC
  - Historically, Canada has not viewed U.S. LLCs (that were FTEs) as residents of the U.S. for treaty purposes
    - *Company is a resident of a treaty country if, under the laws of that country, the company is liable for tax there by reason of residence, place of management, place of incorporation, or similar criteria*
  - Prior to the protocol, this potentially caused several problems
    - Payments of interest, dividends, management fees, etc., from a Canadian resident to an LLC were subject to 25% WHT
    - An LLC that conducted business in Canada not using a PE was unable to rely on the Treaty’s PE provision to exempt it from Canadian tax on business profits
    - There was a 25% tax on all royalties paid to an LLC (unless exempt under domestic law), including certain software and copyright royalties that would otherwise have been subject to a 0% rate
    - An LLC disposing of taxable Canadian property was not entitled to the capital gains exemption under Article XIII of the Treaty

Canada – US Tax Convention: Article IV (Residence)

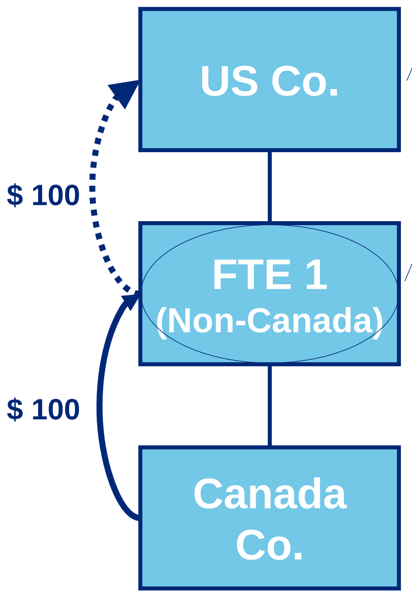
- Background (cont'd):
  - The protocol amends Article IV (Residence) to permit Treaty benefits to certain FTEs, or more accurately, to their members or owners
    - FTEs are entities where the income is taxed at the beneficiary, member or participant level
  - Technical Explanation clarifies which entities are treated as FTEs
    - U.S.:
      - Partnerships
      - LLCs (including entities that may elect disregarded status)
      - Common investment trusts (§ 584)
      - Grantor trusts
    - Canada:
      - Partnerships
      - Bare trusts
  - S-Corporations are largely, but not entirely, fiscally transparent under U.S. law, but not under Canadian law. They are considered by Canada to be eligible for treaty benefits in their own right.

Canada – US Tax Convention: Article IV (Residence)

Background (cont'd):

- Paragraphs IV(6) and IV(7) added to determine whether income is derived by a resident of a treaty country where income is derived through, or received from, an FTE
- Treatment of income, profit and gain under the protocol also depends on whether or not these amounts are subject to the same tax treatment in the jurisdiction of the interest holder (partner or LLC member) as they would be if they had been derived directly by the interest holder
- Technical Explanation states that this determination is made in accordance with the principles of IRC § 894 and Treasury Regulations thereunder

Canada – US Tax Convention: Article IV (Residence), Paragraph 6

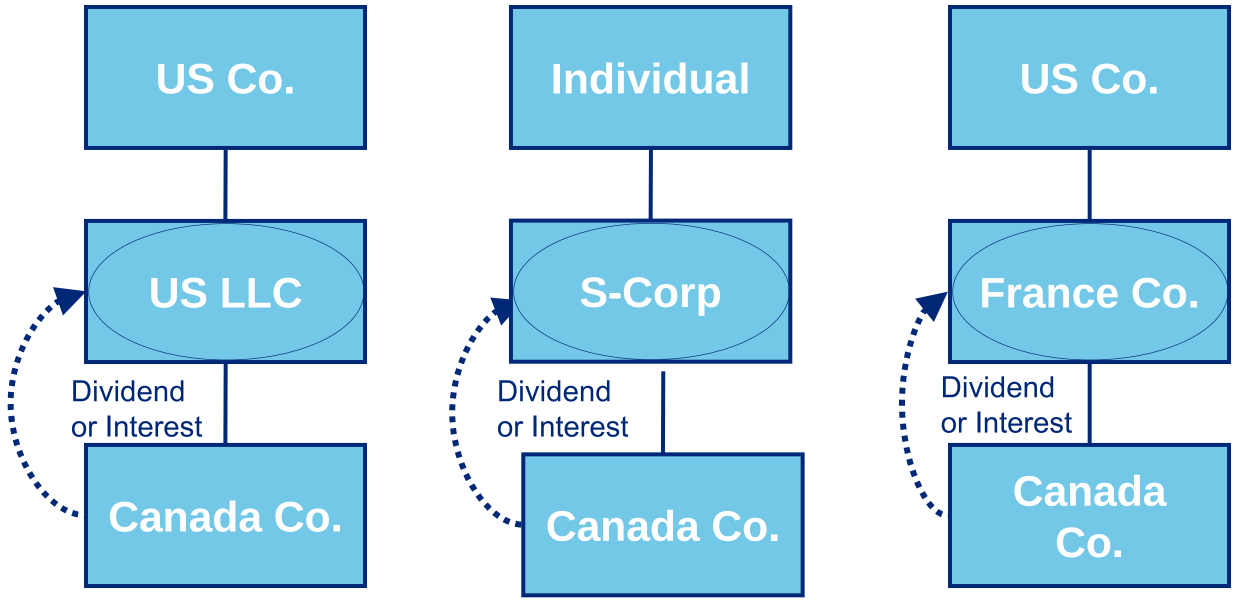


1. Under U.S. tax law, US Co. is treated as having derived $100 through FTE 1, which is not a resident of Canada, and
2. Because FTE 1 is a disregarded entity the $100 derived by US Co. is taxed the same as if it had been earned directly by US Co.

Paragraph 6 allows treaty benefits here not by treating the FTE as a resident person, but by deeming the payment by a Canadian to an FTE to be “derived by” a US member of that FTE. Canada still looks at the FTE as a corporation if the FTE is a LLC or other corporate entity. [Note - if it was a partnership in Cdn view the rule would apply but it wouldn’t be treated as a corp.]

- **“Positive” rule of derived income:**
  - An amount of income, profit, or gain shall be considered to be derived by a person who is a resident of a Contracting State where:
    1. The person is considered under the taxation law of that State to have derived the amount through an entity (other than an entity that is a resident of the other Contracting State); and
    2. By reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is the same as its treatment would be if that amount had been derived directly by that person.

Canada – US Tax Convention: Article IV (Residence), Paragraph 6 Reduced WHT in the following situations



Same result regardless of how the entity is viewed under the tax laws of Canada or France

Canada – US Tax Convention: Article IV (Residence), Paragraph 6

- Taxation of LLCs with Canadian Income
  - Members of LLCs who are U.S. residents who qualify under the Limitation on Benefits Article are entitled to treaty benefits under new paragraph 6 of Article IV
    - Foreign members of U.S. LLCs are not entitled to benefits under the Treaty, even if that member is resident in a country that has a tax treaty with Canada
    - But Canada will continue to view the LLC as the taxpayer, and the LLC must claim the benefit of the reduction in tax on behalf of the member which may provide lower compliance costs than in the case of fiscal transparency
    - For example, the Canada Revenue Agency's position is that Canadian branch tax is reduced in respect of a LLC member that is a US corporation to a rate of 5% and is eliminated in respect of members that are US tax exempt entities BUT NOT in respect of members that are US resident individuals or other non-US residents

Canada – US Tax Convention: Article IV (Residence), Paragraph 6

- Taxation of LLCs with Canadian Income
  - Whether Treaty relief is available for taxable dispositions of Canadian property depends on the type of property and whether all members are U.S. residents who qualify under the Treaty's LOB provisions
  - FTE look-through rule for PE protection: If U.S. resident owns LLC doing business in Canada (but not through a PE), then the U.S. resident will be considered to be carrying on the business, and because the resident has no PE, the business will not be subject to tax

Canada – US Tax Convention: Article IV (Residence), Paragraph 6

- Taxation of LLCs with Canadian Income
  - Deemed versus accrued/deemed paid income –
    - Article IV, paragraph 6 doesn't reduce withholding tax where the income is deemed to have been paid for Canadian tax purposes. For example, deemed dividends under Canadian law.
    - However, Article IV, paragraph 6 should apply where:
      - Amounts have accrued and therefore considered derived/recognized for US tax purposes; and
      - An election has been made to deem the amount to have been paid to ensure deductibility for Canadian tax purposes

Canada – US Tax Convention: Article IV (Residence), Paragraph 6

- Taxation of LLCs with Canadian Income
  - TD Securities (USA) LLC v. The Queen – Tax Court of Canada, April 8, 2010
    - TD Securities (USA) LLC operated in Canada through a branch operation paying Canadian tax
    - Its income was reported on the US consolidated return of its US parent company
    - Company claimed relief from Canadian branch – i.e., 5% under the Canada-US Tax Convention instead of 25% - relief disallowed on assessment by the CRA
    - Court ruled in favour of TD Securities (USA) LLC granting it relief

Canada – US Tax Convention: Article IV (Residence), Paragraph 6

- Taxation of LLCs with Canadian Income
  - TD Securities (USA) LLC v. The Queen – Tax Court of Canada, April 8, 2010
    - Court commented that:
      - *“The decision in this case stands for no more than the proposition that, properly interpreted and applied in context in a manner to achieve its intended object and purpose, the US Treaty’s favourable tax rate reductions apply for years **prior to** [emphasis added] the Fifth Protocol Amendments to the Canadian-sourced income of a US LLC if all of that income is fully and comprehensively taxed by the US to the members of the LLC resident in the US on the same basis as had the income been earned directly by those members”*

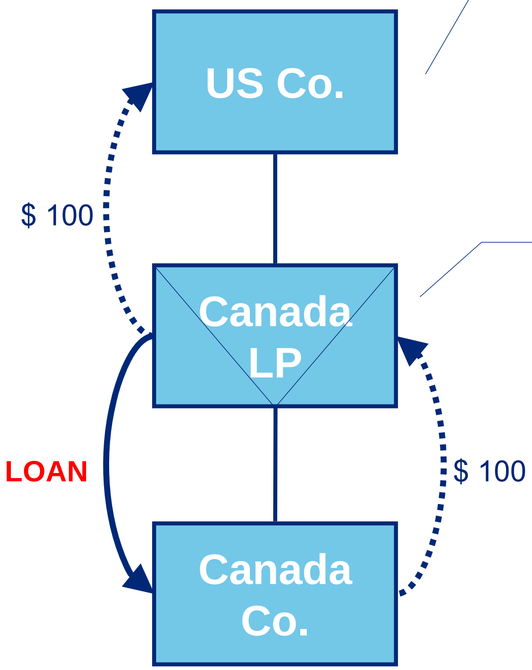
Canada – US Tax Convention: Article IV (Residence), Paragraph 6

- Taxation of LLCs with Canadian Income
  - TD Securities (USA) LLC v. The Queen – Tax Court of Canada, April 8, 2010
    - Canada Revenue Agency's position:
      - Don't necessarily agree with the decision
      - Did not appeal – based on costs versus taxpayers affected
      - Currently reviewing impact of the decision on pre protocol period
      - Potential future guidance of the Canada-US Tax Convention in light of the decision

Canada – US Tax Convention: Article IV (Residence), Paragraph 7

- **New paragraph 7:**
  - New paragraph 7 is designed to deny treaty benefits in respect of certain income earned by non-residents through or from hybrid entities:
    - Canadian flow-through (“LP”) checked to be treated as corporation for U.S. tax purposes (reverse hybrid)
    - Canadian company treated as DRE for U.S. tax purposes (e.g., Nova Scotia ULC, Alberta ULC, British Columbia ULC)
  - The rules eliminate certain double dip financing structures but go beyond that to apply even where no double dip (e.g., dividend payments by ULCs)

Canada – US Tax Convention: Article IV (Residence), Paragraph 7(a)



1.Canada considers US Co. to have derived $100 through Canada LP, which is not a U.S. resident because it is not subject to tax in the U.S.

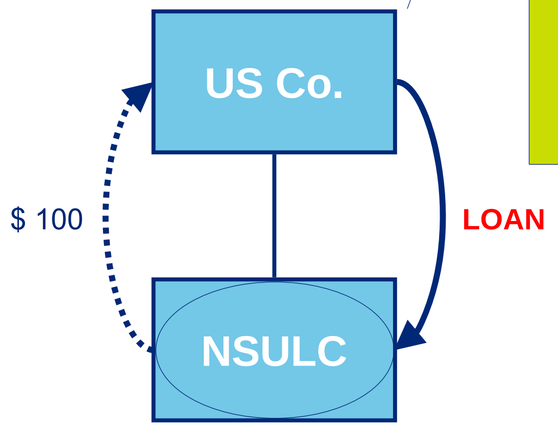
2.Because Canada LP is not fiscally transparent under U.S. tax law, the <u>tax treatment of the $100 in the U.S. is different than if US Co. had received the $100 directly.</u>

Paragraph 7(a) denies zero percent WHT on the interest payment.

Paragraph 7(a)

- An amount of income, profit or gain shall be considered *not to be paid to, or derived by,* a person who is a resident of a Contracting State where:
  1. The person is considered under the taxation law of the other Contracting State to *have derived the amount through an entity* that is not a resident of the first-mentioned State; but
  2. By reason of the entity not being treated as fiscally transparent under the laws of that State, the treatment of the amount under the taxation law of that State is not the same as its treatment would be if that amount had been derived directly by that person.

Canada – US Tax Convention: Article IV (Residence) – Paragraph 7(b)



1. US Co. is treated by Canada as having received $100 from a resident of Canada (i.e., NSULC., because it's subject to taxation there).

2. Because NSULC is fiscally transparent for U.S. tax purposes, the U.S. tax treatment of the $100 is different than it would be if NSULC was not fiscally transparent.

Paragraph 7(b)

- An amount of income, profit or gain shall be considered *not to be paid to, or derived by,* a person who is a resident of a Contracting State where:
  1. The person is considered under the taxation law of the other Contracting State to have received the amount from an entity that is a resident of that other State; but
  2. By reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is not the same as its treatment would be if that entity were not treated as fiscally transparent under the laws of that State.

Canada – US Tax Convention: CRA interpretive positions – ULCs

- Canada Revenue Agency (“CRA”) - guidance provided on ULC and other scenarios
- Whether the treatment is the “same” is based on factors such as:
  - Quantum
  - Timing
  - Character
  - Geography

Examples of potential permitted ULC scenarios:

1. Capitalization of earnings (i.e., deemed dividend) with return of tax paid-up capital
2. Interest paid to U.S. grandparent or to a member of a U.S. consolidated group that is neither a LLC nor owner of the ULC

Canada – US Tax Convention: CRA interpretive positions – ULCs

Examples of potential permitted ULC scenarios (cont'd):

3. Royalty paid (or elected to be deemed paid) to a member of a U.S. consolidated group that is neither a LLC nor owner of the ULC

4. U.S. sole shareholder's gain on the sale of ULC shares to a buyer (rather than a share redemption)

5. A royalty paid by an ULC to an unrelated U.S. licensor

6. Interest paid by an ULC to its U.S. joint corporate shareholders (i.e., ULC treated as a partnership for U.S. tax purposes; U.S. tax treatment not impacted by the ULC's transparency)

Caution – need to review status of CRA's positions, GAAR developments, etc.

Canada–U.S. Tax Convention Fifth Protocol –

Article V, Permanent Establishment

Services

Canada – US Tax Convention: Article V (PE), Services

- Amendments in Article V are a response to *Dudney v. The Queen*
  - Taxpayer resident of U.S. and performed services in Canada as an independent contractor
  - Services provided in Canada for 300 days in 1994 and 40 days in 1995
  - Under old rules (Article XIV), only income derived from a **fixed base** regularly available to the taxpayer in Canada was taxable
  - Taxpayer had no control over premises in Canada, had no freedom to come and go from the building except during business hours, etc.
  - Court found that taxpayer did not have a fixed base regularly available to him and was not subject to tax under the Treaty

Canada – US Tax Convention: Article V (PE), Services

- An enterprise of one State providing services in the other State will be deemed to provide them through a PE in the other State (the "Host State") if:

- **First Test – Paragraph 9(a)**

  i. services are performed in the Host State by an individual present in the Host State for 183 days in any 12-month period, and

  ii. the revenues from such services are more than 50% of the business' gross active business revenues for those 183 days;

    - Definition of "gross active business revenues" is in the Technical Explanation

-- or –

- **Second Test – Paragraph 9(b)**
  – *services are provided in the Host State for 183 days in any 12-month period with respect to the same or connected project* for customers who (i) are residents of the Host State, or (ii) maintain a PE in the Host State (if services provided in respect of such PE)
    - Paragraph 2 of Annex B of Fifth Protocol states that "it is understood that projects shall be considered to be connected if they constitute a coherent whole, commercially and geographically"
    - Definition of "connected projects" is also expanded on in the Technical Explanation

- Effective 2010

- Impact on Reg 105 – under Reg 105, must deduct 15% withholding on service payments but CRA can waive this requirement where Treaty relief demonstrated for no PE in Canada – may be difficult after Article V(9) in force

Canada – US Tax Convention: Article V (PE), Services

- Technical Interpretation 2008-0300941C6
  - The Second Test only applies to the provision of services and only to services provided by the enterprise to third parties
  - CRA takes position that third party means any person other than the person operating the enterprise (including a related party)
  - Definition of Enterprise
  - Same or Connected Project – OECD Example

- Technical Interpretation 2009-0319441C6
  - U.S. Joint Committee on Taxation - para. 9 does not apply to inter-company services
  - CRA re-iterated that in its view a related party may be a “third party” and that Article V cannot give rise to a PE when services are rendered to that enterprise

- Canadian Tax Foundation - 2009 – CRA Round Table
  - U.S. resident service provider engaged by a U.S. multinational and a small portion of the services are provided to a Canadian resident subsidiary of the U.S. multinational
    - CRA of view that Article V(9)(b) could apply
  - CRA stated that where a U.S. enterprise is merely reimbursed for the amount of its compensation costs in respect of an employee that has been <u>seconded</u> to a resident in Canada and the employee is under the supervision of the Canadian resident, the U.S. enterprise would not be seen as providing services in Canada but employee subject to Article XV tax for employment income

Canada–U.S. Tax Convention: Fifth Protocol –

Article XXIX-A Limitation of Benefits

Canada – US Tax Convention: Article XXIX-A – LOB

- Former U.S.- only provision – Article now reciprocal
- First comprehensive LOB provision in any Canadian treaty
- Objective: Denial of treaty benefits to 3rd country ultimate owners; buttress challenge under GAAR, beneficial ownership requirement
- Potential denial of treaty benefits to taxpayers properly resident/beneficial owners, i.e., LOB now an additional qualifier

Canada – US Tax Convention: Article XXIX-A – LOB

Resident's Status	Treaty Benefits
Qualifying Person (Paragraph 2)	All
Active Trade or Business (Paragraph 3)	Income derived in connection with or incidental to such trade or business
Derivative Benefits Test (Paragraph 4)	Reduced withholding tax on dividends, interest and royalties
Competent Authority Determination (Paragraph 6)	All

Canada – US Tax Convention: LOB – Qualifying person

- Paragraph 2:
  - "Qualifying person" = a resident and <u>includes</u>:
    a) Natural person (i.e., individual)
    b) …
    c) Publicly-traded company or trust
    d) Subsidiary of publicly-traded company or trust
    e) Subsidiary and trust of qualifying persons (that meets base erosion test)

Canada – US Tax Convention: LOB - Qualifying person - Private company

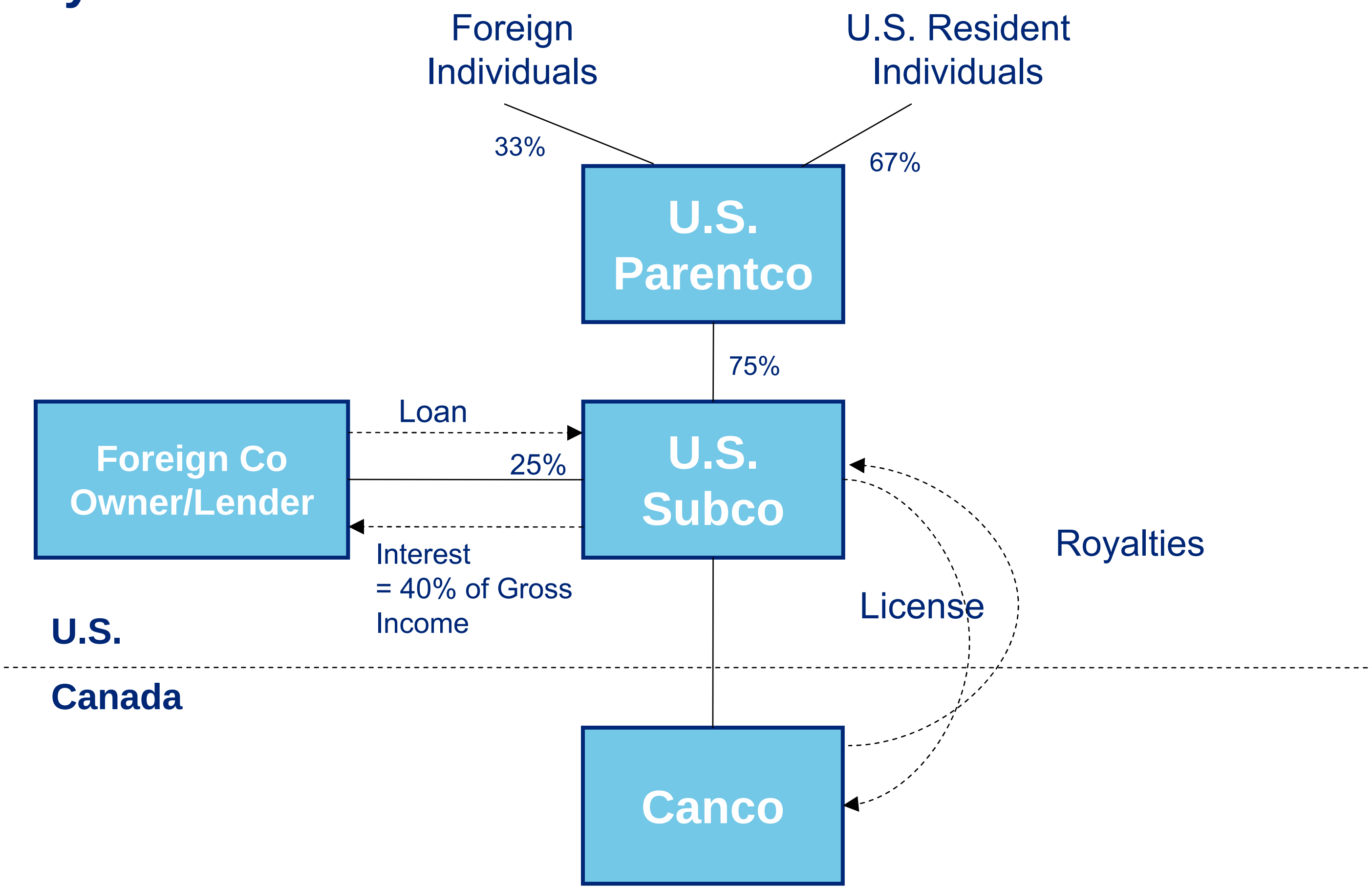
- Companies/trusts which fail the public company subsidiary test can qualify
- Subsidiary or trust, of any qualifying person(s) (e.g., resident individual owners) will qualify if:

1) Any qualifying person(s)
2) Own, directly or indirectly
3) A majority of votes and value of all subsidiary shares; and
    - Ignore debt substitute shares (=distress preferred shares)
4) A majority of votes and value of any disproportionate class of shares of subsidiary
    - Ignore debt substitute shares (=distress preferred shares)

AND

5) "Base erosion test" is met
    - Expenses deductible in the subsidiary's resident state, for its immediately preceding fiscal period, which are paid/payable to non-qualifying persons, <50% of subsidiary's "gross income" (sales less cost of goods sold) for that fiscal period

Canada – US Tax Convention: LOB – Qualifying person – Private company



- U.S. Subco will be a "qualifying person"
  - Qualifying persons own 67% x 75% = 50.25%

    AND
  - "Base erosion test" met

MILLER THOMSON LLP
Barristers & Solicitors
Patent & Trade-Mark Agents

Deloitte.