

**Strafford**

*presents*

# **U.S.-Canada Cross Border Corporate Tax Challenges**

**Planning and Compliance Strategies Given Latest  
Guidance and Regulation Changes**

**A Live 110-Minute Teleconference/Webinar with Interactive Q&A**

**Today's panel features:**

Jonathan Garbutt, Barrister and Solicitor, **Garbutt Tax Law**, Toronto, ON, Canada

Merv Edwards, Managing Director, **Ceteris Canada Inc.**, Toronto, ON, Canada

Duane Milot, **Cassels Brock**, Toronto, ON, Canada

**Wednesday, October 6, 2010**

The conference begins at:

**1 pm Eastern**

**12 pm Central**

**11 am Mountain**

**10 am Pacific**

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# **U.S.-Canada Cross Border Corporate Tax Challenges Webinar**

**Oct. 6, 2010**

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# Today's Program

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# **Sect. 116 And Taxable Canadian Property**

**Duane Milot, Cassels Brock**

# Sect. 116 And Taxable Canadian Property



- Introduction
  - Federal budget 2010 introduced significant changes to the taxation of non-residents and their reporting and withholding obligations.
  - Until now, certain investments (including shares of private Canadian companies) were taxable in Canada, unless a treaty exemption applied.
  - The compliance burden was significant and deterred foreign investment in Canada.

# Sect. 116 And Taxable Canadian Property (Cont.)



- Tax Act
  - The general rule is that a non-resident of Canada is required to pay tax on the disposition of “taxable Canadian property,” subject to any exemptions provided in a tax treaty.
  - Sect. 116 imposes reporting and withholding requirements to ensure that the appropriate amount of Canadian tax is paid on dispositions of taxable Canadian property by non-residents.
  - The Tax Act provides that the Purchaser is liable to pay 25% of the value of the property to the Receiver General, unless it receives from the vendor a “clearance certificate” issued by the Minister of National Revenue indicating that the appropriate amount of tax has been paid or confirming that any gain would be exempt from tax under a tax treaty.
  - As a result, the purchaser generally insists on withholding 25% of the proceeds of disposition until receipt of a satisfactory clearance certificate. Otherwise, at a designated time, the purchaser would remit the amount to the Receiver General.

# Sect. 116 And Taxable Canadian Property (Cont.)



- Tax Act (Cont.)
  - The process involved in applying for a clearance certificate was often long (up to a year) and complicated, especially where there were multiple vendors, where proceeds of disposition were paid in shares or earn-outs, or in cases involving flow-through entities.
    - E.g., each individual limited partner of a venture capital fund was required to apply.
  - Foreign investors were required to file Canadian tax returns in the year of disposition.

# Sect. 116 And Taxable Canadian Property (Cont.)



- Federal budget 2008
  - Budget 2008 attempted to make the rules more workable with the concept of “treaty exempt property,” and introduced changes which were only useful for transactions involving related parties.
  - The changes did not go far enough, and the previous compliance burden remained a practical reality for non-arm’s length transactions.

# Sect. 116 And Taxable Canadian Property (Cont.)



- Federal budget 2010
  - Greatly simplifies the Sect. 116 clearance certificate process for many types of property, by amending the definition of “taxable Canadian property.”
  - Shares of private Canadian corporations and certain interests in partnerships and trusts will generally no longer constitute taxable Canadian property.

# Sect. 116 And Taxable Canadian Property (Cont.)



- Federal budget 2010 (Cont.)
  - Liability and compliance remains in effect for shares or interests in partnerships and trusts that, at any time in the 60-month period prior to the sale, derived more than 50% of their value directly or indirectly from real property in Canada, Canadian resource property or timber resource property.
    - 25% or more ownership requirement (with related parties) for corporations listed on a designated stock exchange, or for mutual funds

# Sect. 116 And Taxable Canadian Property (Cont.)



- As a result of the changes, an offshore “blocker entity” such as a Luxembourg subsidiary, which was previously used to make the Canadian investment (and which were costly and complex legal structures), can now be eliminated.
- These changes received royal assent and are now in force.

# **Foreign Entities And Trusts Update**

**Duane Milot, Cassels Brock**

# Foreign Investment Entities And Foreign Trust Regimes



- Proposals were first introduced in the 1999 federal budget.
- Numerous versions of the regimes have been released over the last 10 years.
- These regimes attempt to tax in Canada, offshore income that should be properly taxed in Canada.
- Latest draft legislation was released on Aug. 27, 2010.

# Foreign Investment Entities



- Federal budget 2010 proposed to retain the offshore investment fund property provisions that are currently in force (Sect. 94.1) and repeal the foreign investment entity proposals.
- The current provisions require an income inclusion with respect to an interest in an “offshore investment fund property” in certain circumstances.
- Federal budget 2010 broadens the existing rules to apply to certain trusts and extends the normal reassessment period.
- These measures apply for taxation years that end after March 4, 2010.

# Foreign Investment Entities (Cont.)



- In order for Sect. 94.1 to apply:
  - The shares or other interests must derive their value, directly or indirectly, primarily from “portfolio investments” owned by the non-resident entity; and
  - One of the main reasons for the purchaser acquiring the shares (or other interest) is to avoid tax under the Tax Act that would have applied to the income generated from the underlying assets of the corporation (or other entity), if such income had been earned directly by the purchaser.

## Foreign Investment Entities (Cont.)



- If Sect. 94.1 were to apply to purchasers, each such purchaser must include in income a notional amount equal to a prescribed rate of interest applied to the “designated cost” of the taxpayer’s interest in the non-resident entity.
  - The “designated cost” of an interest in the non-resident entity is its cost plus any imputed amounts included in income under Sect. 94.1 for any preceding year.

## Foreign Investment Entities (Cont.)



- The former “FIE” proposals were vastly more complex and have been repealed in their entirety.
- The current “offshore investment fund property” regime is arguably easier to apply. However, the rules have not been extensively applied by the Canada Revenue Agency and have been largely ignored by Canadian taxpayers.
- The rules should reduce a non-resident’s compliance burden.
- These changes may affect U.S. executives who are residents of Canada and have certain foreign investments.

# Foreign Trust Regime



- Federal budget 2010 changes to the foreign trust regime are also generally relieving.
- Existing rules deem a non-resident discretionary trust to be resident in Canada if it has a resident contributor and a related resident beneficiary. Such a trust is required to pay tax on its income in the same manner as other residents of Canada.
- Former proposals (prior to the Federal budget 2010)
  - They would have applied to non-resident trusts with a resident contributor, regardless of the current existence of a Canadian beneficiary.
  - They would also apply where the non-resident trust had a Canadian beneficiary, and the contributor had been resident in Canada within five years of having made the contribution.
  - A deemed resident trust would have been taxed on all of its income regardless of the source, and would generally have made both resident contributors and resident beneficiaries jointly and severally liable for tax payable by a trust deemed resident in Canada.

## Foreign Trust Regime (Cont.)



- Federal budget 2010 proposals generally excluded from Canadian taxation any income arising from property contributed to the trust by non-residents of Canada (except for Canadian source income).
- Income of the trust is also attributable to its resident contributors in proportion of their contributions to the trust.
  - They will not be jointly and severally liable for the trust's own income tax obligations.

## Foreign Trust Regime (Cont.)



- The trust is also entitled to a deduction for the income payable to its beneficiaries in the year and for amounts attributed to resident contributors.
- Carve-out for:
  - Tax-exempt entities that could have been jointly liable for tax liability despite tax-exempt status
    - E.g., pension plans
  - *Bona fide* commercial trusts (definition of exempt foreign trust has been expanded)
  - Loans made by a Canadian financial institution
- Measures generally apply for the 2007 and subsequent taxation years. Attribution rules apply only to taxation years that end after March 4, 2010.

# Update On Foreign Affiliates



- Unlike the U.S., where dividends from related corporations are included in income, Canada has a very generous exemption system for foreign affiliates (FAs).
- However, where a controlled foreign affiliate earns foreign accrual property income (FAPI), the attribution of FAPI to a resident is very similar to the U.S. Subpart F look-through rules.

# Update On Foreign Affiliates (Cont.)



- FAPI is largely passive income of a foreign affiliate
  - Income from property
  - Income from business other than active business
  - Taxable capital gains from dispositions of certain property
- FAPI is a net amount computed under Canadian tax rules.

# Update On Foreign Affiliates (Cont.)



- The carryforward period for being able to utilize foreign accrual property losses (FAPLs) is being extended to 20 years.
  - The change aligns these rules with the domestic loss carryforward periods, which have been repeatedly extended in recent years.
  - A foreign affiliate's FAPLs will continue to be able to be carried back for three years.

# Update On Foreign Affiliates (Cont.)



- Proposed changes align the definition of permanent establishment under the Tax Act with the definition under Canada's modern tax treaties.
  - These changes could affect the Canadian tax on existing structures and may create issues relating to allocation to surplus accounts.

# Update On Foreign Affiliates (Cont.)



- Substantial revisions have been made to rules that deal with the interaction between foreign affiliate surplus balances and the winding-up bump under paragraph 88(1)(d) of the Tax Act.
- New provisions relating to the computation of surplus and deficit accounts of foreign affiliates held by partnerships

# Update On Foreign Affiliates (Cont.)



- Recent proposals do not deal with the winding-up of a foreign affiliate.
  - Existing rules under subsection 88(3) would not apply the concept of paid-up capital.
  - It is unclear how the proposed new rules dealing with foreign paid-up capital would apply.
  - Consequently, it is unclear how the winding-up of a foreign affiliate should be taxed.

# **Transfer Pricing Issues For U.S. Companies**

**Merv Edwards, Ceteris Group**



## **Agenda For This Section**

### **Transfer pricing issues for U.S. companies**

- **Recent court rulings**
- **Emerging Issues in transfer pricing for multi-nationals**
- **Fifth Protocol - Arbitration**



## Recent Cases – *Glaxo Smith Kline*

### *Glaxo SmithKline Inc.*

- Taxpayer bought ranitidine, the active ingredient in ulcer drug Zantac, from Adechsa, a related non-resident company during the 1990-1993 period.
- GSK also paid a 6% licensing fee to parent company for the rights to:
  - Manufacture, use and sell products
  - Use the trademark for Zantac and other products
  - Purchase raw materials
  - Support marketing of the product
- GSK paid \$1,512 to \$1,651 per kilogram, while generic manufacturers paid \$194 to \$304 per kilogram.
- Zantac-branded products commanded a significant premium over comparable generic products in the marketplace.



## Recent Cases – *Glaxo Smith Kline (Cont.)*

- The Tax Court of Canada agreed with the CRA’s position that the price paid by the generic companies represented a comparable uncontrolled price (CUP) as well as the “fair market price.”
- The TCC determined that the “reasonable in the circumstances” test in the old transfer pricing legislation, ss69(2), could be limited to the determination of the fair market price.
- TCC disregarded the licensing arrangement.
- CRA reassessed to reduce the taxpayer’s cost by \$51 million, due to exceeding the “fair market price” based upon the price paid by generic pharmaceutical manufacturers for ranitidine.



## **Recent Cases – *Glaxo Smith Kline* (Cont.)**

The Federal Court of Appeals reversed the TCC's decision on the basis that:

- Zantac brand commanded a premium over generic substitutes.
- The license agreement allowed GSK access to a portfolio of products.
- The license agreement cannot be ignored in evaluation of transfer price.
- The “reasonable in the circumstances” standard requires all factors to be taken into consideration.



## ***GE Capital Canada***

Relates to guarantee fees paid by GE Capital Canada to U.S. parent

### **Basic facts**

- **GE Capital Canada (GE Canada) paid fees to parent for unconditional guarantees of publicly issued commercial paper and debentures.**
- **The guarantee fee was 1% of the principal amount of debt outstanding in the year.**
- **The fee boosted GE Canada's credit rating to AAA, the same as its parent's.**
- **The CRA disallowed deductions of \$136 million for the 1996 to 2000 tax years.**
- **The CRA argued that a guarantee fee was not necessary, since implicit support was assumed by parent.**



## ***GE Capital Canada (Cont.)***

### **Implicit support concept**

- **GE Canada was a core subsidiary, and parent would not allow them to fail.**
- **Similar to a metaphorical “invincible wallet”**
- **No benefit to GE Canada**
- **Contradicts arm’s length principle**



## ***GE Capital Canada (Cont.)***

### **Arm's length principle**

- **Court accepted “yield” approach and difference between BBB-/BB+ and AAA is 1.83%, and even with implicit support the 1% guarantee is lower than 1.83%**
- **GE Canada believes that an unrelated bank or insurance company would have charged them 3% to guarantee \$7 Billion in debt.**



## **Emerging Transfer Pricing Issues - Business Restructuring**

OECD issued new chapter in guidelines on business restructurings on July 22, 2010.

The chapter addresses taxpayers that unbundle and reassemble parts of their value chain - essentially when a company changes the functions performed, risks assumed and/or assets used of the entities within the corporate group. Examples include:

- **Changing an entity from a manufacturer/distributor to a limited-risk distributor**
- **Changing a full-fledged manufacturing entity to a contract manufacturing entity**
- **Centralizing the procurement function for the entire group of companies**
- **Creating intangible holding companies**



## Emerging Transfer Pricing Issues - Business Restructuring (Cont.)

- The chapter offers guidelines on:
- Whether and when internal business restructuring transactions require arm's length compensation or indemnification,
- How transfer pricing rules should be applied to the parties to a business restructuring transaction following the restructuring, and
- Whether and when governments have the ability to disregard a taxpayer's restructuring for purposes of applying transfer pricing rules.



# Emerging Transfer Pricing Issues - Intangibles

- The OECD starting a new project on transfer pricing aspects related to intangible property including a sale, a license or an intangible that is put at the disposal of another party.
- Issues to consider include:
  - Economic vs. legal ownership
  - Definition of intangibles
  - Compensation for value producing services, processes, know-how, etc.
  - Valuation, from transferor's and transferee's perspective
  - Valuation methods



# Arbitration

- Applies to double taxation cases that can't be mutually agreed to at competent authority
- Jan. 1, 2009 implementation
- Applies to double-taxation cases that cannot be resolved within two years of the “commencement date”
- Three conditions are required to be met:
  1. Tax returns must be filed
  2. No agreement within two years of commencement date
  3. Taxpayer and advisers agree to keep all information received from arbitration panel on a “confidential” basis

The third requirement effectively provides the taxpayer with a veto over the procedure.



## Arbitration (Cont.)

- **Two-year period ends January 2011**
- **CRA and IRS have arrived at a “meeting of the minds” on how to apply to APAs**
- **Close to issuing a memorandum of understanding and operational guidelines on the overall process**
- **Current government officials will not serve as arbitrators.**

# **Permanent Establishment And Beneficial Owner**

**Duane Milot, Cassels Brock**

# Update On “Permanent Establishment”



- *Knights of Columbus v. The Queen*, 2008 DTC 3648 (TCC)
  - This landmark decision dealt with the meaning of “permanent establishment” (PE) under paragraph 1 and paragraph 5 of the Canada-U.S. Tax Treaty (U.S. Treaty).
  - The concept of PE is of primary importance for non-residents of Canada, since only income allocated or attributable to a PE in Canada is subject to tax in Canada.

# Update On “Permanent Establishment” (Cont.)



- Under the U.S. Treaty, a PE generally means a fixed place of business through which the business of the U.S. entity is wholly or partly carried on.
  - This includes (a) a place of management, (b) a branch, (c) an office, (d) a factory, and (e) a workshop.
- A dependent agent will be deemed a PE of the U.S. entity if it has and habitually exercises the authority to conclude contracts in the name of the U.S. entity.

# Update On “Permanent Establishment” (Cont.)



- U.S. Fraternal Benefit Society (“Knights”) was reassessed for its 1999 to 2002 taxation years on the basis that its sales agents, while carrying on their own business in Canada, were contemporaneously carrying on the business of the Knights through their home office.
- Canada Revenue Agency (CRA) issued reassessments even though for the 1992 to 1998 years, CRA had vacated similar reassessments on the basis that the Knights had no PE.

# Update On “Permanent Establishment” (Cont.)



- Tax Court of Canada (TCC)
  - In order for the field agent’s office to constitute a fixed place of business of the Knights, it must be:
    - i) A place of some permanence
    - ii) That is a place of business, and
    - iii) Through which the business of the Knights is carried on.

# Update On “Permanent Establishment” (Cont.)



- TCC
  - The Knights must have a right of disposition over these premises (e.g., OECD commentary provides the place of business must be “at the disposal” of the enterprise).
  - The phrase “at its disposal” was key to the analysis and was intended to mean circumstances in which the non-resident might be viewed as having a sufficient degree of control over the premises or the business activities carried on through the premises.
  - The Knights had no PE since (i) there was no control over the offices, (ii) they could not make any operational decisions at or in respect of the offices, and (iii) they bore no expense or risk in respect of the offices.
    - No Knights staff, no Knights signage, no meeting of applicants

# Update On “Permanent Establishment” (Cont.)



- TCC
  - Found that there was no dependent agent PE under paragraph 5 of Article V, since the field agents did not have the power to habitually conclude contracts in Canada on behalf of the Knights.
    - Three contracts: Permanent insurance contract, temporary insurance agreement and retention contracts.
      - Contracts must relate to operations that constitute “business proper” of the non-resident.
      - Final approval was in the U.S., not with the field agents, so concluded in the U.S.

# Update On “Permanent Establishment” (Cont.)



- Knights decision is good news for U.S. taxpayers that want to do business in Canada.
- Factors to consider in PE analysis:
  - Whether the activities are carried out on a regular basis, and the importance of the business activities
  - The scale of the activities carried on in Canada (e.g., employees, equipment, capital investment)
  - Use, control or legal right to control the premises
  - Who made management decisions or bore the risks of the operation
  - If there are any Canadian employees at the premises
  - Legal agreements between parties
- Intention of the Treaty drafters and OECD commentary are important.

# Update On “Beneficial Owner”




- *Prévost Car Inc. v. The Queen*, 2008 DTC 3080 (TCC), affirmed by 2009 DTC 5053 (FCA)
- Dealt with the taxation of cross-border dividend payments within a multinational group of companies
- Focus was on the meaning of “beneficial owner” under Article X of the Canada-Netherlands Tax Treaty
- Concept of “beneficial owner” is also relevant in other Treaty articles, including with respect to payments of interest and payments of royalties

# Update On “Beneficial Owner” (Cont.)



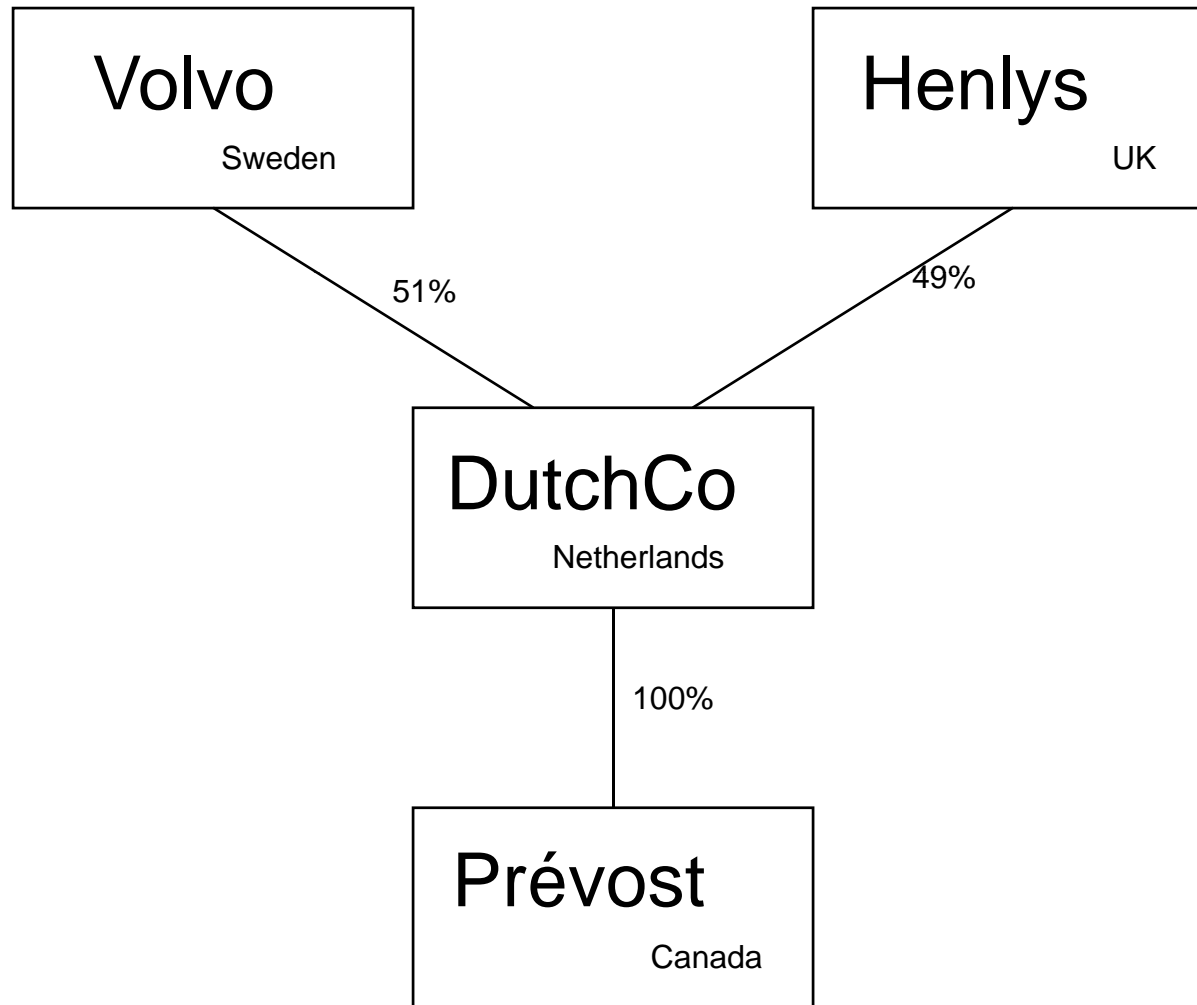
- Under Part XIII of the Tax Act, there is withholding tax at the rate of 25% on dividends paid by a corporation resident in Canada to a non-resident person.
- If the recipient of the dividend payment is resident in a country that has entered into a tax treaty with Canada, there is usually a reduction of the withholding tax rate to between 5% to 15%.

# Update On “Beneficial Owner” (Cont.)



- Prévost was a Canadian company that manufactured buses in Québec and North America.
- In 1995, the shareholders of Prévost agreed to sell their shares to Volvo Bus Corp. (a company resident in Sweden) and to Henlys Group PLC (a company resident of the United Kingdom).
- Instead of acquiring the shares of Prévost directly (51:49 respectively), Volvo and Henlys incorporated a Dutch holding company (“DutchCo”), which then acquired all of the shares of Prévost.

# Update On “Beneficial Owner” (Cont.)



# Update On “Beneficial Owner” (Cont.)



- Prévost makes dividend payments totaling CAD 90 million between 1996 and 2001.
- Shareholder agreement provided that 80% of annual profits of Prévost would be paid out in dividends.
- The rate of withholding tax under the Canada-Netherlands Tax Treaty on dividends was 5%, whereas that rate would have been higher if the dividends had been paid by Prévost directly to Volvo (10%) or Henlys (15%).
- There was no withholding between the Netherlands and Sweden, or between Netherlands and the U.K., due to a Netherlands tax exemption.
- The issue was whether DutchCo (no employees, no other assets) was the “beneficial owner” of dividends paid to it by its wholly owned Canadian subsidiary, Prévost.

## Update On “Beneficial Owner” (Cont.)



- Crown argued that the DutchCo was a mere “conduit,” since it routinely paid all of the dividends onward to its two shareholders.
- The affairs of DutchCo were administered by a local trust company.
- Some of the resolutions or minutes of Prévost had mistakes, and some banking documents suggested that Volvo and Henlys were *de facto* shareholders of Prévost.
- Prévost called several experts to explain Dutch law and the OECD model conventions and commentaries.

# Update On “Beneficial Owner” (Cont.)



- TCC held that:
  - The “beneficial owner” of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend received.
  - The “beneficial owner” is the person who enjoys and assumes all the attributes of ownership.
  - The dividend is for the owner’s own benefit, and this person is not accountable to anyone.
  - The dividends were an asset of DutchCo and were available to its creditors.
- No evidence that DutchCo was a conduit, and no evidence of an automatic flow of funds

# Update On “Beneficial Owner” (Cont.)



- FCA agreed with TCC.
- The decision provides greater certainty for multi-national organizations.
- More flexibility to arrange their affairs with respect to reduced treaty rates for dividends, interest and royalties
- It appears to be difficult for the CRA to argue that a holding company is a mere conduit.

# Update On “Beneficial Owner” (Cont.)



- One does not look through a corporation to its shareholders as the beneficial owners of corporate property, unless the corporation has absolutely no discretion to deal with the property on its own.
- A holding corporation is regarded as the beneficial owner of its property and, as such, is entitled to the protection of a tax treaty.

# **Entities And Hybrids**

**Jonathan Garbutt, Garbutt Tax Law**

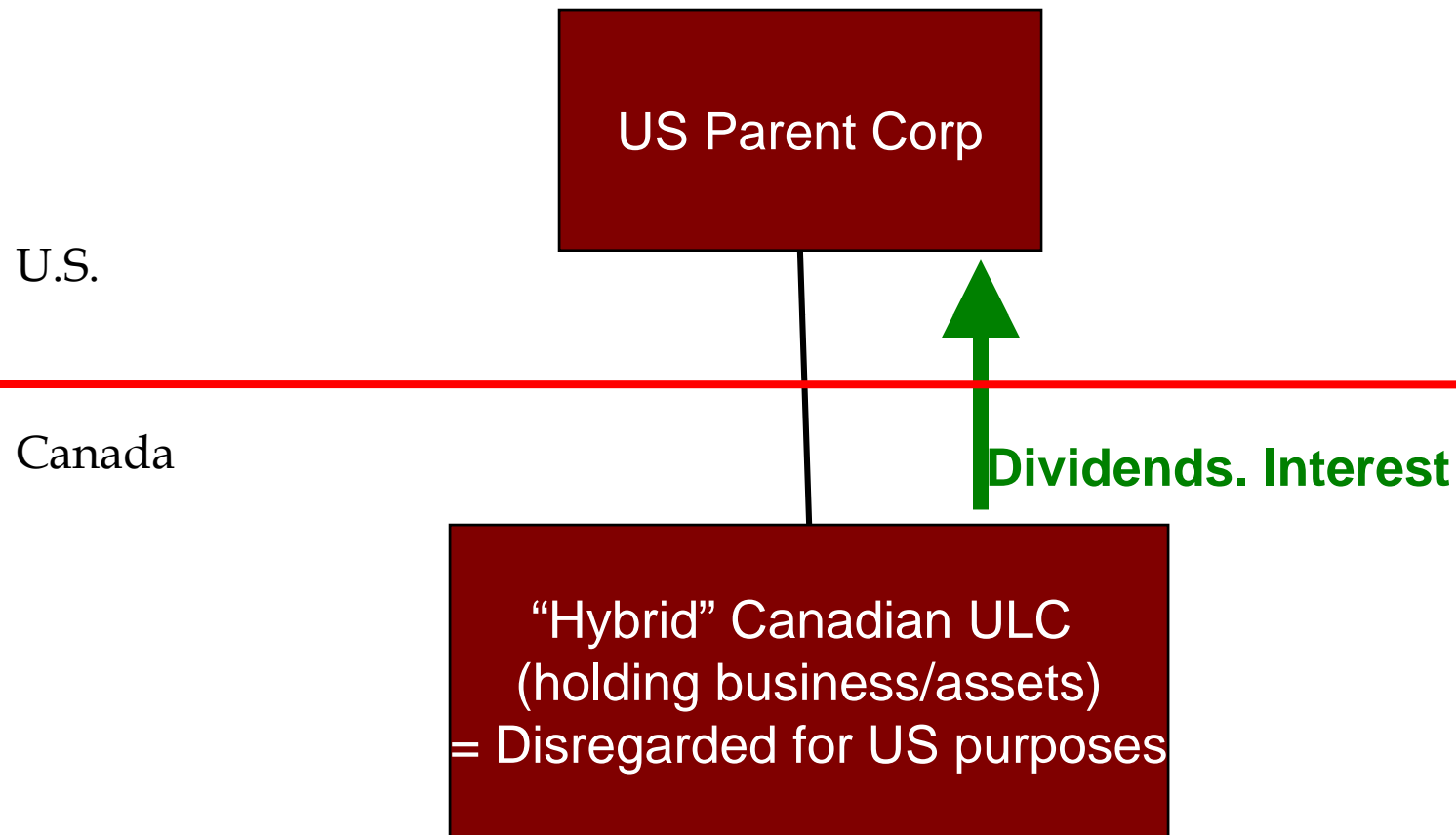
# 5<sup>th</sup> Protocol Anti-Hybrid Provision: Art. IV(7)

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

# Canadian Inbound Structure #1

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

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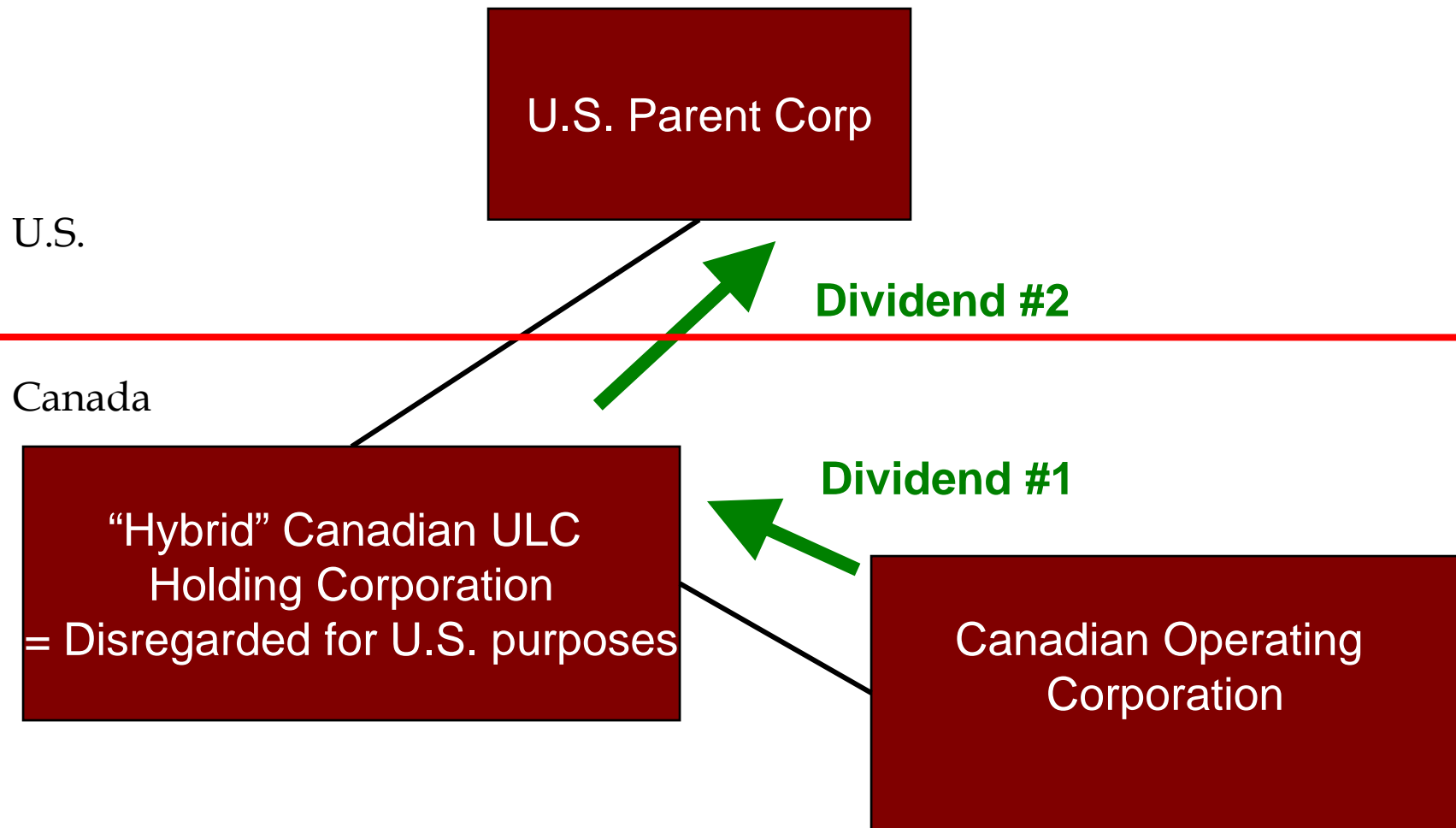
- Typical structure: U.S. ParentCo with OpCo ULC in Canada
- Under Canadian taxation law, U.S. ParentCo receives dividends from a corporation resident in Canada
- Canadian ULC fiscally transparent in the US
- Dividend received full treaty protection, and because USCo owned more than 10% of shares of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

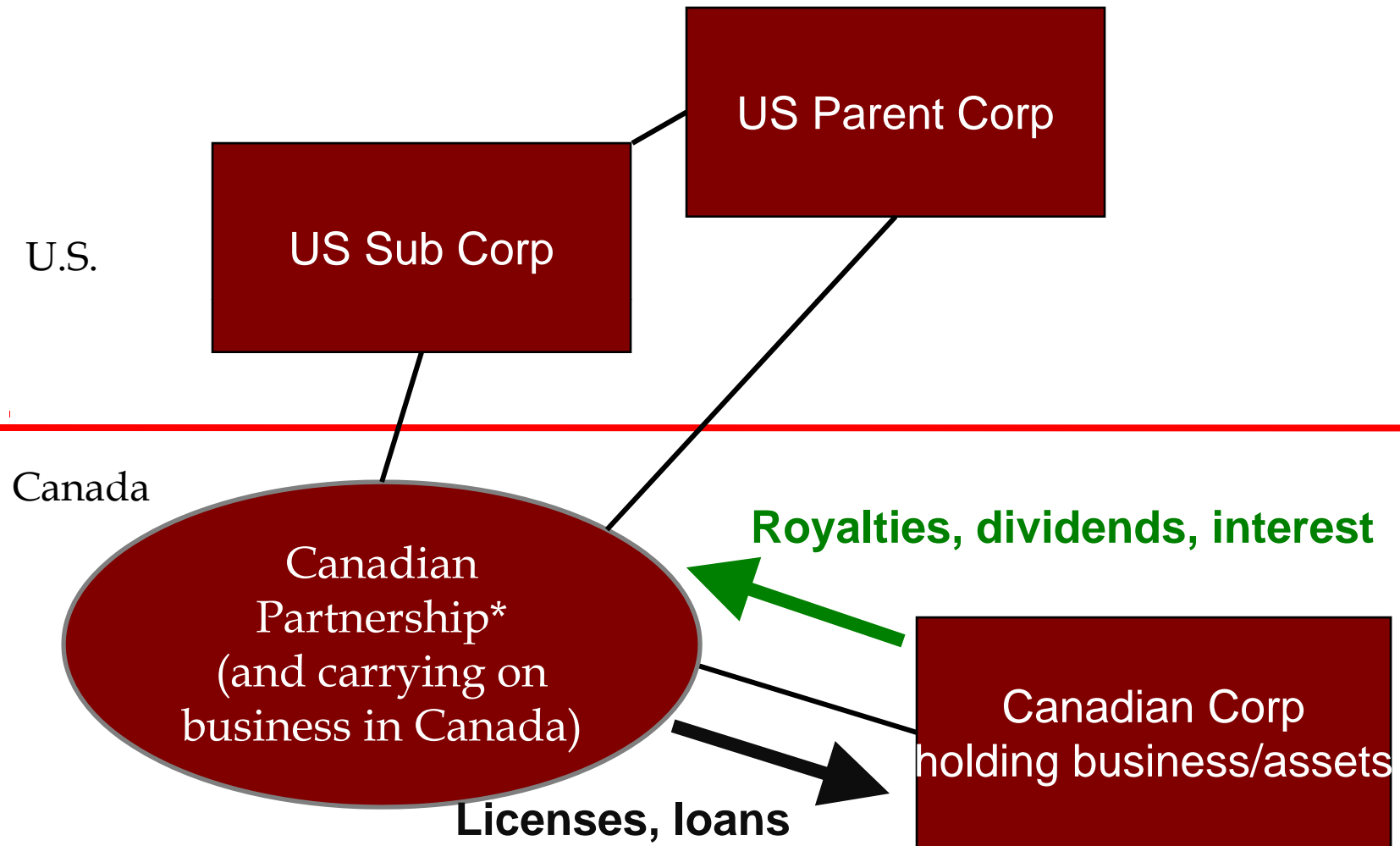


# Impact Of Art. IV(7) On Structure #2

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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, and Hybrid ULC HoldCo pays a dividend to USParentCo of same or similar amount.
  
- From a U.S. 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 U.S. 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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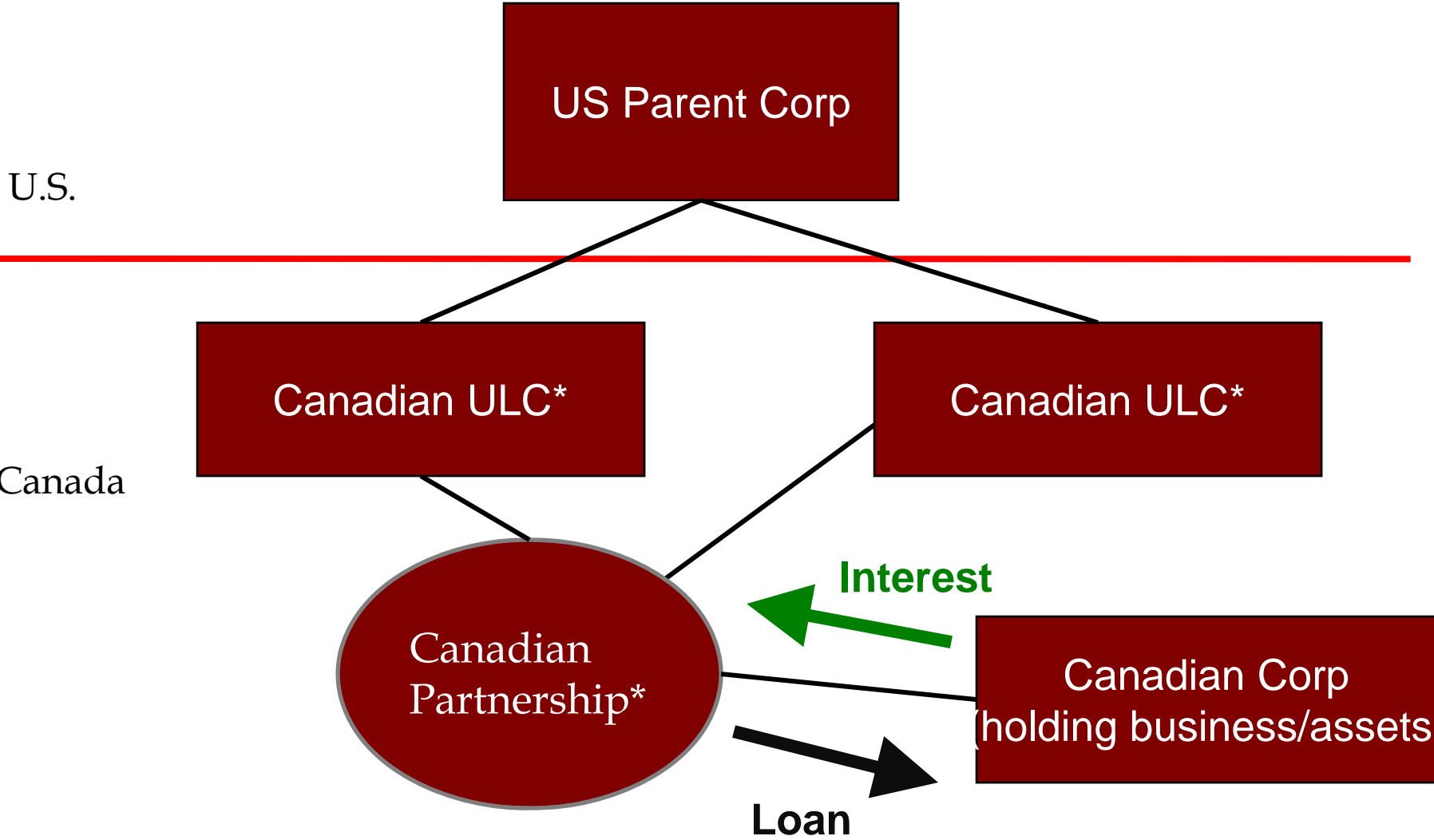
- Canadian partnership treated as corporation for U.S. purposes
- Income earned by Canadian partnership generally not taxable in U.S. until cash distributed
- Interest or other expense deduction in Canada, no income inclusion in U.S.
- Income earned by partnership by “carrying on business” also not treaty 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 U.S.
- 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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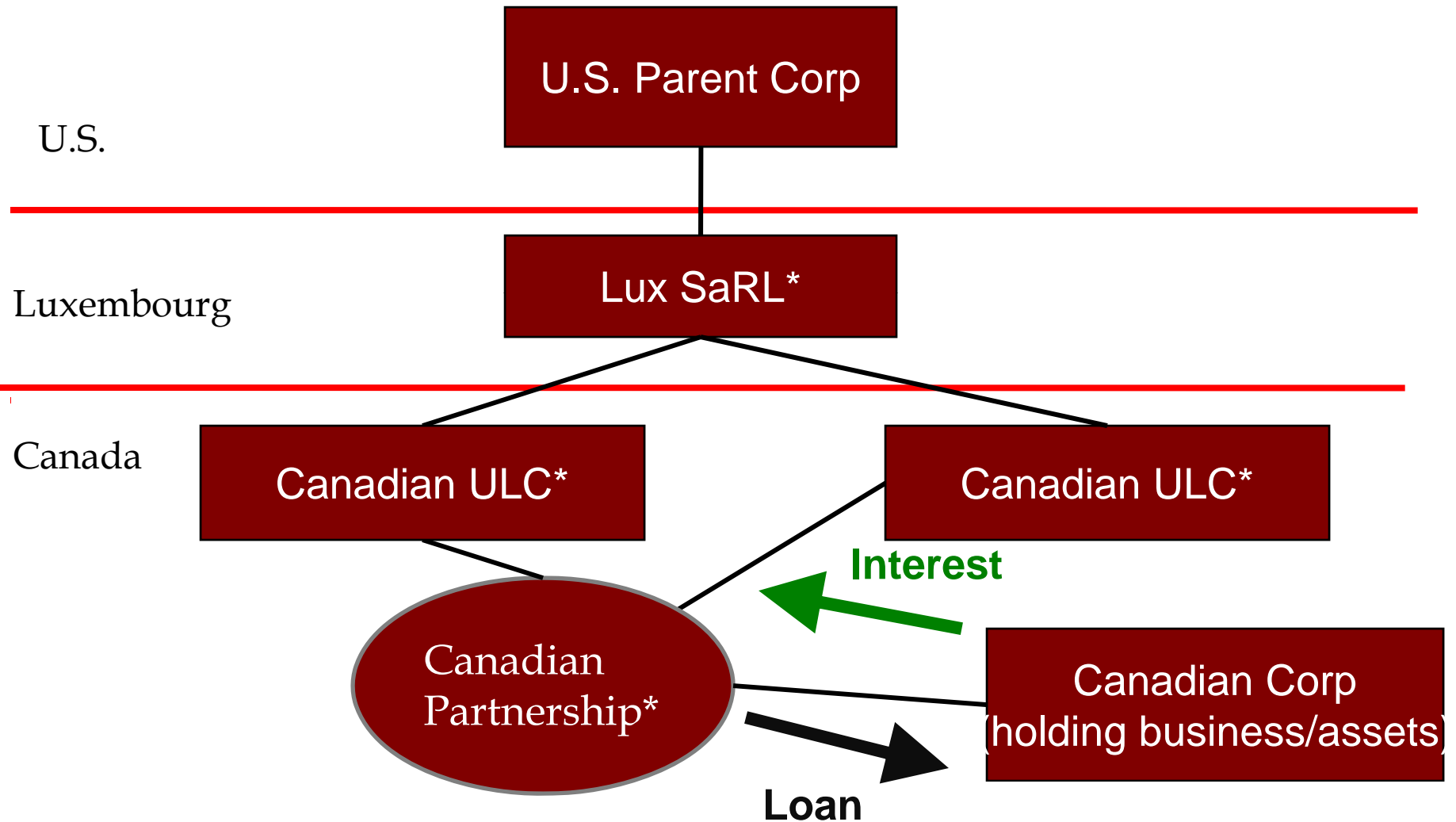
- Same as previous structure, U.S. Parent Co injects the form of equity and loans (Canadian thin cap rules)
- Canadian ULCs and partnership treated as corporations for U.S. purposes
- Income earned by Canadian partnership generally not taxable in U.S. until cash distributed
- Interest deduction in Canada, no income inclusion in U.S.
- 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 U.S. shareholder and Hybrid ULC subsidiary
  - Increase and reduction of paid-up capital (PUC) by Hybrid ULC
  - Interest payments by Hybrid ULC to U.S. 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



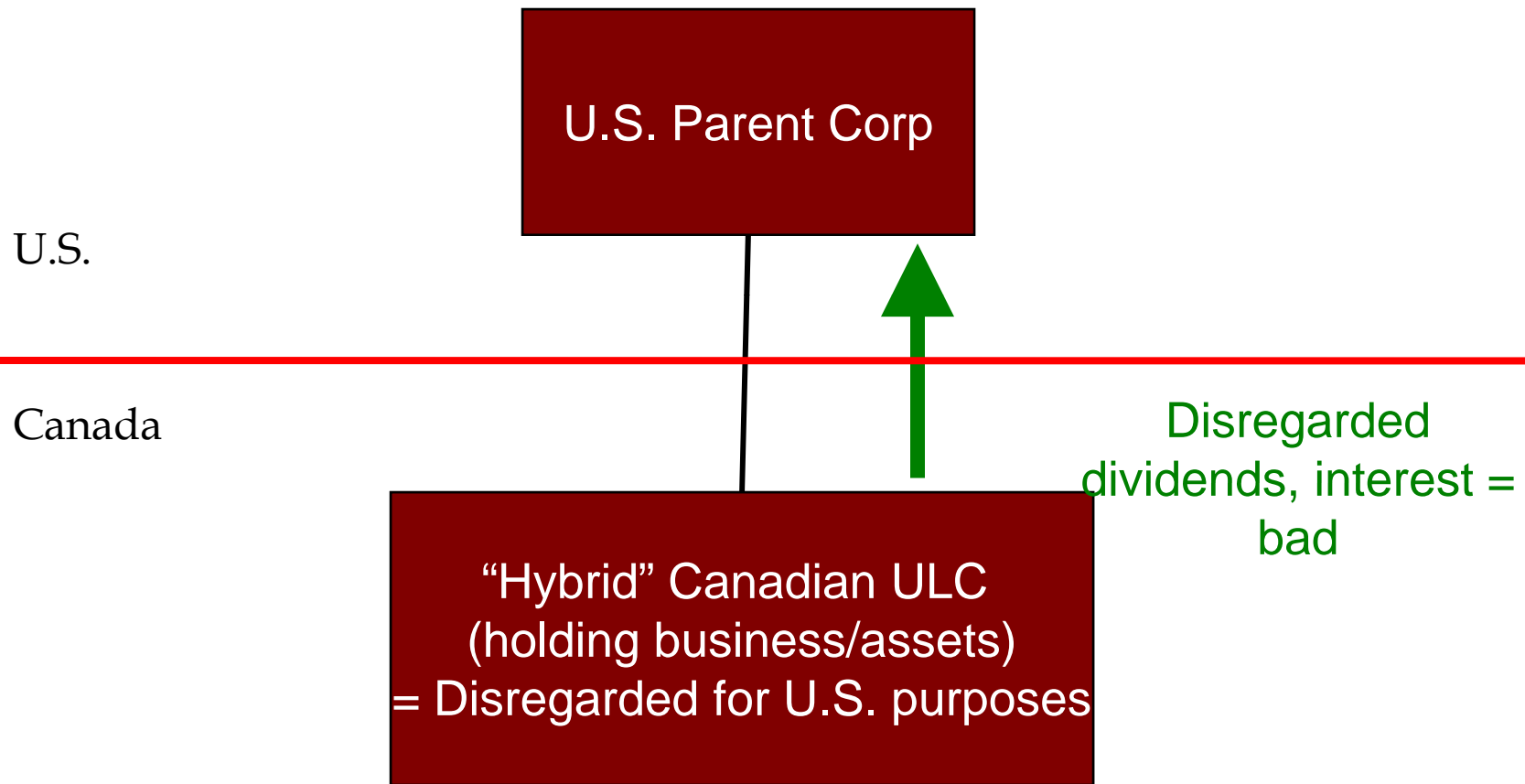
# CRA OK Ex. 1: Third Country Solution

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

# CRA-Approved Example #2: Playing With PUC

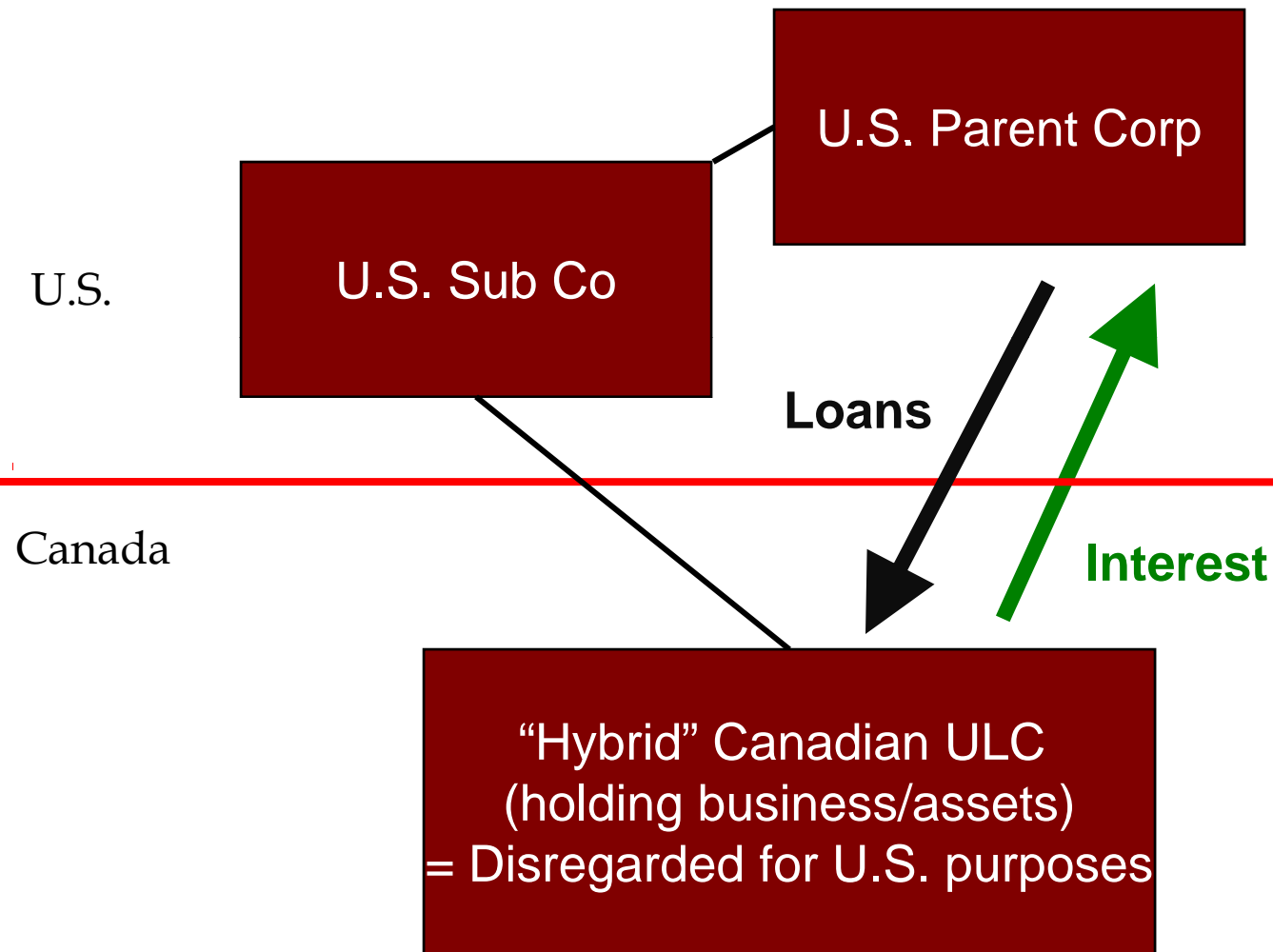
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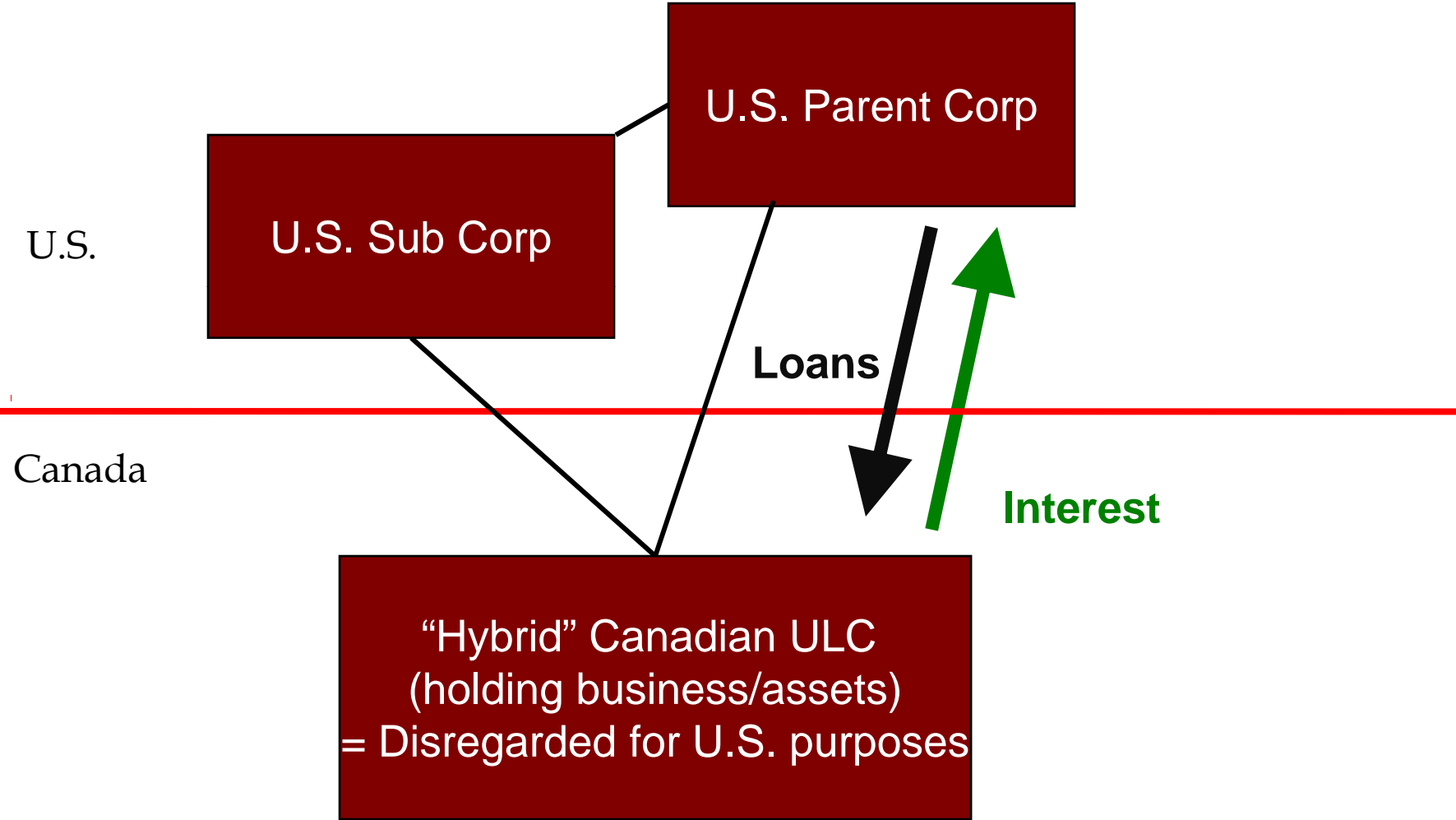
Dividend in Canada but return of capital in U.S., or capital reduction/deemed dividend in Canada, proceeds of disposition or a return of capital for U.S tax purposes = OK

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# CRA-Approved Example #3: Grandparent Debt



# CRA-Approved Example #4: 2 Shareholders



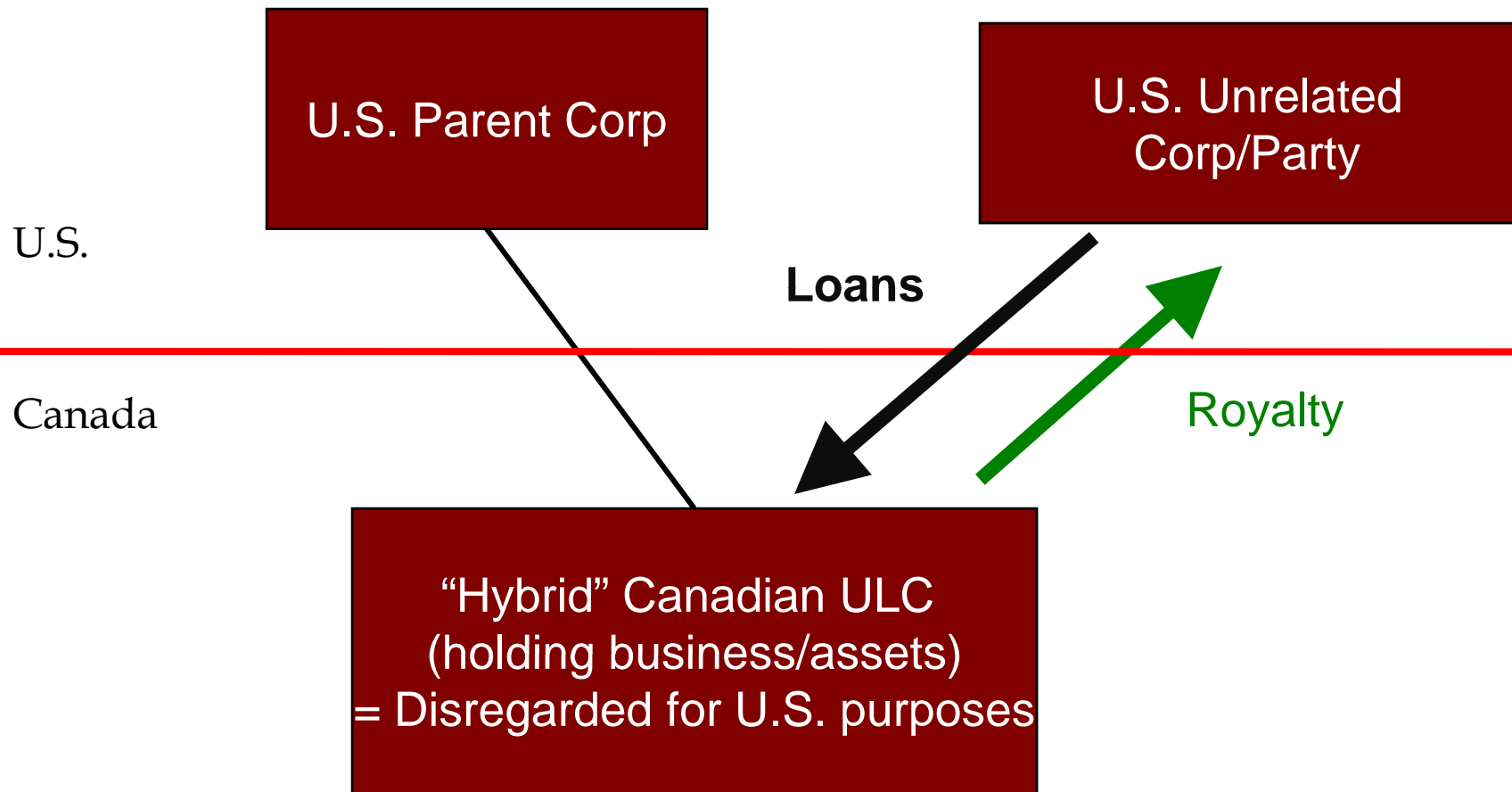
# CRA OK Ex. 5: Sale Of Hybrid ULC

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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 U.S. and Canadian tax law.
- CRA Position: Art. IV(7)(b) does not apply to arm's length sale; USParentCo is exempt for Canadian capital gains tax under the Treaty.

# CRA-Approved Example #6: Third-Party Royalties

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# CRA OK Ex. 6: Third-Party Royalties

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- US ParentCo owns 100% of the shares of Hybrid ULC
  - Hybrid ULC is granted a right to use patent by a third party
  - Third party is resident in U.S. 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 And LLCs

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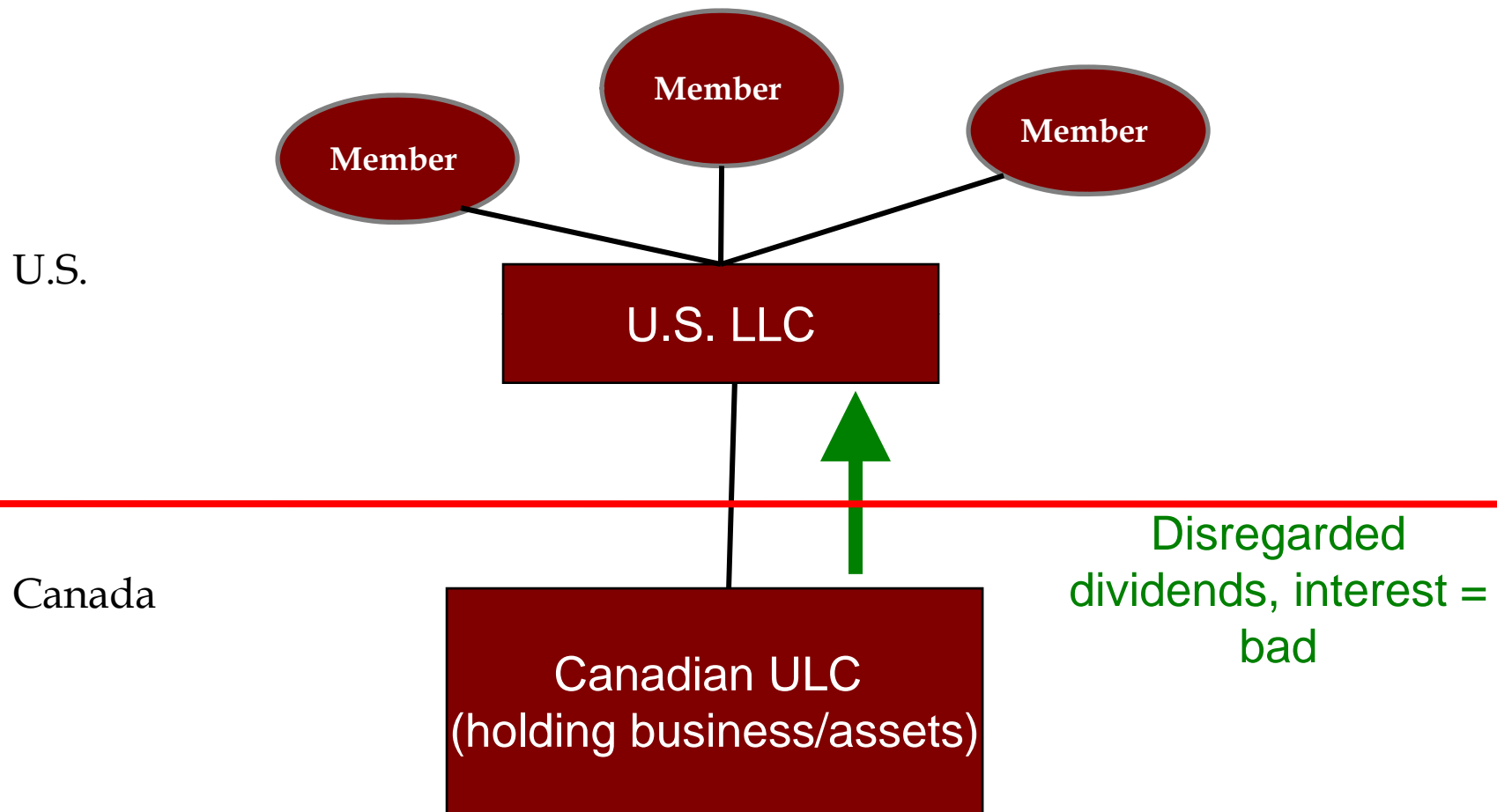
- LLCs: Under the 5<sup>th</sup> protocol, U.S. LLCs now recognized as resident in the U.S. pursuant to Art IV(6)
- *TD Securities* case: TCC ruled LLCs resident in the U.S. without the Treaty, but specifically does not deal with post-5<sup>th</sup> Protocol period.
- Still does not solve problems
 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

# CRA Positions – Changes And Reassurances

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- Feb. 17, 2010: 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 U.S. purposes but tax treatment is different.

# U.S. LLC Parent With OpCo In Canada



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

# **LB Provisions In Tax Treaty**

**Jonathan Garbutt, Garbutt Tax Law**

# Introduction

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- The new Limitation on Benefits (LoB) provision in Article XXIX A limits to treaty benefits provided by Canada to U.S. residents is now in force.
- Prior to the 5<sup>th</sup> Protocol, the LoB previously applied only to benefits granted by the U.S. to Canadian residents, in respect of their transactions involving the U.S. 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 U.S. resident, but also satisfy other tests.

## Introduction (Cont.)

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

# General Rule Of Application

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- Art. XXIX A (1): In order to be entitled to benefits of the Treaty, a U.S. resident must:
  - Be a “qualifying person”, as (defined in Art XXIX A(2));  
or
  - Meet the exceptions provided in paragraphs 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 U.S. 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 (Cont.)

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- Subsidiaries of public companies (par. 2(d))
  - If more than 50% of votes and value owned by at most five 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 are 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 U.S.
  - Income derived in Canada is connected with or incidental to U.S. activity.
  - U.S. activity is substantial compared to business in Canada.
- Treaty applies to income derived from such business.

## Non-Qualifying Persons: Partial Benefits (Cont.)

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- Derivative benefits test (par. 4)
- U.S. 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-U.S. treaty rate
  - Or, if expenses paid/payable to non-qualified persons are 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 (GAAR) in s. 245 of the act.

# **Withholding Changes In Tax Treaty**

**Jonathan Garbutt, Garbutt Tax Law**

# 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 U.S. resident entities with Canadian subsidiaries and operations.
- Withholding rate applied to “non-participating interest” paid by Canadian residents to U.S. residents that are not at arm’s length will be 0% for 2010 onward.
- Deductibility of non-arm’s length interest payments is 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.

# s.216 Trust

