The Joint Committee on Taxation of
The Canadian Bar Association
and
The Canadian Institute of Chartered Accountants

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January 8, 2008

Mr. Brian Ernewein
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Tax Policy Branch
Department of Finance Canada
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Ottawa, ON K1A 0G5

Dear Mr. Ernewein:

Re: Fifth Protocol

Enclosed is our submission on a number of matters which we recommend be addressed in the Department of Finance's discussions with the United States Department of the Treasury in connection with the Department of the Treasury's Technical Explanation of the Fifth Protocol to the Canada-United States Income Tax Convention.

We have also commented on other concerns which, if not appropriate to deal with in the Technical Explanation, we recommend be addressed by Canada. One of these concerns is the application of Article IV(7) of the Convention to deny the treaty rate of Canadian withholding tax on dividends paid to a U.S. resident by a Canadian unlimited liability company out of earnings have been subject to full Canadian taxation.

Another concern is the need for Canada to develop procedures to enable U.S. persons to establish their entitlement to treaty benefits on amounts paid to them by Canadian payers. Unless these matters are addressed, we are concerned that there will be significant practical difficulties in administering the Canadian withholding tax provisions.

If you have any questions or require elaboration of any of the matters discussed in the enclosed, please speak to either one of us.

We look forward to discussing our submission with you.

Yours truly,

Bruce Harris, CA
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

Paul Tamaki
Chair, Taxation Committee
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Submission of the
CICA-CBA Joint Committee on Taxation

Protocol Amending the Convention Between
Canada and the United State of America With
Respect to Taxes on Income and Capital

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Protocol Amending the Convention Between Canada and the United States of America With Respect to Taxes on Income and Capital

A. Introduction

On September 21, 2007 the Governments of Canada and the United States of America signed the fifth protocol ("Protocol") amending the convention ("Convention") between Canada and the United States of America with respect to taxes on income and on capital.

The purpose of this submission is to highlight a number of issues which the Committee recommends be addressed in the forthcoming Technical Explanation ("Technical Explanation") which we understand will be prepared by the United States Department of the Treasury with input from the Canadian Department of Finance. In addition we have commented on other matters which, if not appropriate to address in the Technical Explanation, we recommend be addressed by Canada.

The following abbreviations are used throughout this submission:

Act	Canadian federal Income Tax Act
FTE	entity that is treated as fiscally transparent under the laws of the relevant State
LLC	United States limited liability company
source country	the Contracting State in which the income, profit or gain, as the case may be, arises
residence country	the Contracting State in which the person deriving or receiving the income, profit or gain, as the case may be, is resident

Unless the context otherwise requires, references to provisions of the Convention are to such provisions as amended by the Protocol.

B. Article IV of the Convention (Residence)

Article IV of the Convention will be amended to add two new paragraphs dealing with FTEs.

According to the Backgrounder which was issued with the Department of Finance Press Release No. 2007-070 (September 21, 2007), new paragraph 6 of Article IV ("FTE Relieving Rule") provides that income that a resident of the residence country earns through a “hybrid entity” will in certain cases be treated by the source country as having been earned directly by a resident of the other country. We understand that, for this purpose, a “hybrid entity” refers to an entity that is treated as an FTE in one country and as a taxable entity under the laws of the other country. Paragraph 7 of Article IV (“FTE Corollary Rule”) is described as providing that if a hybrid entity’s income is not taxed directly in the hands of its investors (resident in the residence country), it will not be treated (by the source country) as earned by a resident of the other country.

There are several important terms used in these two provisions which are not defined. How the FTE Relieving Rule and the FTE Corollary Rule are intended to apply is not clear in some circumstances. As discussed below, there is also a concern that the FTE Corollary Rule will result in an inappropriate loss of treaty benefits.

1. Meaning of “Fiscally Transparent”

The expression “fiscally transparent” is not defined in the Protocol nor is it a term commonly used in the Canadian domestic tax context. We recommend that the meaning of this term be addressed in the Technical Explanation.

In particular, we recommend that the Technical Explanation address whether the following entities are FTEs under the laws of Canada:

(a) partnership,

(b) trust which is “an arrangement under which the trust can reasonably be considered to act as agent for all the beneficiaries under the trust with respect to all dealings with all the trust’s property” (i.e., a “bare trust”) that is not described in any of paragraphs (a) to (e.1) of the definition of “trust” in subsection 108(1) of the Act, and

(c) trust to which the attribution rule in subsection 75(2) of the Act applies.

We also recommend that the Technical Explanation address whether, and in what circumstances, the following entities are FTEs under the laws of the United States:

(a) partnership,

(b) grantor trust,

(c) LLCs, Canadian unlimited liability companies and other entities in other jurisdictions that are treated as disregarded entities or partnerships under United States tax laws, and

(d) U.S. Subchapter “S” corporations and qualified Subchapter “S” subsidiaries.

In a technical interpretation dated April 03, 1995,[1] the Canada Revenue Agency expressed the view that a Subchapter "S" corporation is a resident of the United States under the current version of the Convention because it is liable to tax in the U.S. on its world wide income and is only treated as a flow through entity because of an election made by its shareholders and will be subject to tax in the U.S. on its world wide income if certain conditions are not met. This suggests that there would be a change in Canadian administrative interpretation and practice if a Subchapter "S" corporation is considered to be an FTE under the Convention as amended by the Protocol. The analysis is similar for a U.S. qualified Subchapter "S" subsidiary.[2]

2. Residence of Partnerships

The FTE Relieving Rule refers to an FTE that is not resident in the source country and the FTE Corollary Rule refers to an FTE that is not resident in the residence country.

If a partnership can be an FTE, we recommend that it be clarified whether the partnership can be considered to be resident in Canada or the United States and, if so, how such residence should be determined. Article IV of the Convention provides that a person is resident in Canada or the United States, as the case may be, if it is liable to tax therein by reason of domicile, residence, citizenship, etc. A partnership is not liable to tax in Canada and, therefore, we submit that a partnership cannot be a resident of Canada for the purposes of the Convention. On the other hand, while a partnership is not normally subject to tax in the United States, it can elect to be taxed in the United States as a corporation. We submit that it follows that a partnership cannot be considered to be a resident of the United States for the purposes of the Convention unless it has elected to be taxed as a corporation.[3]

3. Meaning and Consequences of "Derived"

Where the FTE Relieving Rule applies, the relevant income, profit or gain is considered to be "derived" by the relevant resident of the residence country. This provision does not go on to provide that the amounts "derived" by the resident are considered to have all of the characteristics necessary to benefit from the operative relieving provisions of the Convention – in other words, that amounts considered to be derived by a resident of a residence country are also considered to be:

(a) income "beneficially owned" by the resident, in the case of dividends, interest, and royalties paid to or derived by the FTE,

(b) dividends on stock owned by the resident, in the case of dividends on stock owned by the FTE,

(c) business profits of the resident, in the case of business profits of the FTE,

[1] Document number: 9416455
[2] Canada Revenue Agency Document 9816355 (September 2, 1999)
[3] Canada Revenue Agency Document 2005-0140221R3 (October 05, 2005).

(d) business profits of the resident attributable to a permanent establishment situated in the source country, in the case of business profits of the FTE attributable to a permanent establishment situated in the source country, and

(e) gains from the alienation of property of the resident, in the case of gains from the alienation of property of the FTE.

We understand that the FTE Relieving Rule is intended to afford to a resident member of the FTE the benefit of the relevant provisions of the Convention applicable to such income, profit or gain. We recommend that this be confirmed in the Technical Explanation.[4]

4. Meaning of "Treatment"

The FTE Relieving Rule only applies if the "treatment" of the amount derived through the FTE is the same as its treatment would be if it were derived directly by the resident of the recipient country. The FTE Corollary Rule could apply where the treatment of an amount derived through an FTE is not the same as its treatment would be if the amount were derived directly, or where the treatment of an amount received from an FTE is not the same as its treatment would be if the FTE were not fiscally transparent. The meaning of the word "treatment" is unclear and we recommend that it be clarified in the Technical Explanation.

For example, treatment could simply mean the retention of the character of income and the time income is recognized. Alternatively, the term could be interpreted so that "treatment" is considered to be different if different provisions of the domestic tax legislation applied to the income, for example, where source and character remain unchanged but section 96 of the Act applies to determine a member's share of income rather than a direct inclusion in the income of a taxpayer. Similarly, an amount may be considered to be treated differently even if character remains unchanged, but the payer and/or amount of the income differs from the original source payment.

We recommend that the Technical Explanation clarify the relevant factors in applying the "same treatment" requirement. We recommend that examples be set out in the Explanatory Notes to illustrate the application of the relevant factors. For example, if a Canadian unlimited liability company is an FTE under United States tax law and a wholly owned subsidiary of a U.S. resident, would the FTE Corollary Rule apply to deny treaty benefits to royalties paid by the FTE to an arm's length U.S resident third party? In other words, would the "treatment" of the royalty to the third party under the laws of the United States the same as it would be if the unlimited liability company were not an FTE?[5]

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[4] Canadian compliance issues in claiming the benefits of the Convention are discussed below.

[5] If a subsection 75(2) trust is considered to be an FTE, we request clarification of how the FTE Relieving Rule and FTE Corollary Rule are intended to apply to a Canadian or U.S. 75(2) trust where the person to whom the relevant income is attributed either is or is not also a beneficiary of the trust. For example, if a Canadian subsection 75(2) trust is an FTE, would U.S. source dividend income that is attributed to the Canadian resident settlor (who is not a beneficiary of the trust) be considered to be subject to the "same treatment" considering that any U.S. withholding tax on the dividend is not attributed and cannot be claimed

Also, would the FTE Corollary Rule apply to deny treaty benefits to a U.S. person who disposes of a share of a Canadian private corporation to a Canadian unlimited liability company that is unrelated to the U.S. seller but is an FTE under the U.S. tax laws? In particular, would the U.S. seller's gain on the sale be "received" from the FTE and, if so, would the treatment of the gain be the same as it would be if the purchaser were not an FTE?

5. Consequences of the Application of FTE Relieving Rule

The example in the Backgrounder states that, where U.S. investors use a LLC to invest in Canada, and all of the investors are taxed in the U.S. on the income in the same way as they would be had they earned the income directly, Canada will treat the income as having been paid to a U.S. resident.

This example does not address the application of the provision where the FTE has multiple investors, only some of which are taxed in the residence country. We recommend that it be clarified in the Technical Explanation that the FTE Relieving Rule will apply to the portion of the income, profit or gains that are derived by the persons resident in the residence country, whether or not other persons derive income, profit or gain from the FTE.

We also recommend that it be clarified that the FTE Relieving Rule applies to income, profit or gain derived by a resident through one or more tiers of FTEs.

We recommend that the treatment of investors resident in the source country be clarified. For example, would Canadian withholding tax be applicable to Canadian-source income derived by a resident of Canada through a U.S. partnership or LLC?

6. Application of the FTE Corollary Rule Where No Tax Arbitrage

The effect of the FTE Corollary Rule is that, if an FTE earns income from the source country that is not taxed directly in the hands of its investors in the residence country, the income may not be entitled to treaty benefits under the Convention. We are concerned that this may cause inappropriate results in some circumstances.

For example, if a Canadian resident corporation holds an interest in an LLC that is an FTE under U.S. taxation law and carries on business in the United States, the treatment of the income from that business under Canadian taxation law will not be the same as the treatment if the business income had been derived directly by the Canadian resident. Consequently, the after-tax income of the LLC will not be eligible for reduced branch tax rate under the Convention notwithstanding that it has been subject to full U.S. taxation.

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as a foreign tax credit by the settlor? If not, then the FTE Relieving Rule would not appear to apply. Alternatively, would a U.S. resident 75(2) trust with U.S. source dividend income that is attributed to a Canadian settlor (who is also a beneficiary of the trust) be subject to the "same treatment" if subsection 75(2) did not apply and such dividends were included in income under paragraph 108(5)(a)? If not then the FTC Corollary Rule would seem to apply to result in no treaty relief in respect of U.S. withholding tax on the dividend.

Similarly, the FTE Corollary Rules would deny the benefits of reduced rates of withholding tax under the Convention in respect of dividends, interest or royalties paid to a U.S. resident by a Canadian unlimited liability company which is an FTE under U.S. taxation law, notwithstanding that the Canadian company has been subject to full rates of Canadian corporate tax on the income earned by it. While we understand that there may be policy concerns about providing a reduced rate of Canadian withholding tax on interest or royalties that are deductible under Canadian tax law and not taxable under United States tax law, such tax arbitrage does not exist in the case of non-deductible dividends paid by the Canadian company. For example, if a family-owned U.S. corporation has previously established a Canadian unlimited liability company to expand its business into Canada, we submit that dividends out of the after-tax income of the Canadian business should not be denied the treaty rate of withholding tax.

We recommend that Canada and the United States agree not to apply the FTE Corollary Rule where the amount in question is not deductible under the tax law of the source country – for example in the case of dividends or the purchase price of non-depreciable capital property, such as shares of a Canadian private corporation.

C. Article X of the Convention (Dividends)

Article X of the Convention will be amended to provide that, in determining whether the beneficial owner of a dividend is a company which owns at least 10 percent of the voting stock of the company paying the dividends, a company that is a resident of the residence country will be considered to own the voting stock owned by an entity that is an FTE under the laws of the residence country and that is not a resident of the source country, in proportion to the company's ownership interest in that FTE.

We recommend that the method of determining the proportion of a company’s ownership interest in one or more tiers of FTEs be clarified.

D. Article XV of the Convention (Income from Employment)

1. $10,000 Exclusion in Article XV(2)(a)

Paragraph 2 of Article XV of the Convention will be amended to delete the words: “a calendar year” from the preamble and subparagraph 2(b) will be amended to refer to “any twelve month period.” As a result, it is unclear how the exemption in subparagraph 2(a) for remuneration not exceeding $10,000 is to be applied. We recommend the Technical Explanation clarify how (over what period) the $10,000 test in subparagraph 2(a) is to be applied.

2. Remuneration “Paid by or on Behalf of” or “Borne by”

The exemption in paragraph 2(b) will not be available in respect of remuneration that is either paid by or on behalf of a person who is a resident of the source country or borne by a permanent establishment in the source country. We request clarification whether or not the reference to "permanent establishment" in paragraph 2(b) includes a permanent establishment of a resident of the source country.

How is this provision intended to apply where a parent (that is not resident in the source country and does not have permanent establishment in the source country) provides ongoing management services to a subsidiary in the source country on a cost reimbursement basis, and officers or employees of the parent travel to the source country from time to time in connection with such services? If the remuneration of these individuals is actually paid by the parent, is such remuneration paid "on behalf of" the subsidiary or "borne by" a permanent establishment of the subsidiary in the source country?

If remuneration can be "paid by or on behalf of" or "borne by" an entity other than the employer, what degree of tracing is necessary? For example, if an employer provides services in the source country to a resident of the source country ("service recipient") using employees who are resident in the residence country, would the remuneration of the employees be considered to be paid by or on behalf of the service recipient or borne by a permanent establishment of the service recipient in the source country, in either case no matter how the fees are determined (for example, fixed rate versus cost reimbursement or hourly charge)?

E. Article XXIX A of the Convention (Limitation on Benefits)

As discussed below, there are a number of issues in the interpretation of Article XXIX A of the Convention ("LOB") which we recommend be addressed in the Technical Explanation. Unless these matters are clarified, we expect that many U.S. persons will be applying to the Canadian Competent Authority under paragraph 6 of the LOB for a determination of these issues regarding their entitlement to treaty benefits.

1. Prior U.S. Technical Explanation

The U.S. technical explanation of the current version of the Convention contains various statements about the interpretation of the LOB which previously were relevant only for the purposes of United States taxation. We recommend that the Government of Canada provide a statement as to the extent to which it adopts the comments in that technical explanation in applying the LOB for the purposes of Canadian taxation.

2. Definition of "Qualifying Person"

A "qualifying person" is defined in paragraphs 2(d) and (e) of the LOB with reference to "ownership" of shares of a company or beneficial interests in a trust by other qualifying persons. For this purpose, an FTE would not be a qualifying person because it would not itself be a resident of a Contracting State, but could be regarded as "owner" of shares of the company or interests in a trust held by the FTE.

We recommend confirmation in the Technical Explanation that, if an entity is an FTE under the laws of either or both of Canada and the United States, it will be similarly disregarded for the purposes of applying the LOB.

3. Meaning of “Principal Class” and “Primarily and Regularly Traded”

Paragraph 2(c) of the LOB refers to a company or trust whose principal class of shares or units (and any disproportionate class of shares or units) is “primarily and regularly traded” on one or more recognized stock exchanges. We recommend that the meanings of these terms be clarified.

4. Base Erosion Test

Paragraphs 2(e) and 4(b) of the LOB contain a “base erosion test” which refers to expenses deductible from the gross income of a company or trust that are paid or payable “directly or indirectly” to persons that are not qualifying persons. The words “directly or indirectly” have been added under the Protocol. In many cases, it will not be possible for a company or trust to identify whether or the extent to which an expense is payable to a qualifying person. It does not seem reasonable to include expenses paid by an entity to unrelated third parties. An example would be where a significant expense of a company is interest on widely-held debt. Furthermore, the meaning of “directly or indirectly” is not clear and suggests that the company is required to identify the “indirect” payees of its expenses, even where the “direct” payee is an unrelated third party. We recommend that these matters be clarified in the Technical Explanation.

5. Active Trade or Business Test

Paragraph 3 of the LOB contains expressions which may have a different meanings under Canadian and United States tax laws. For example, paragraph 3 refers to income derived from the source country “in connection with or incidental to” a trade or business actively conducted in the residence country. In *Ensite Limited v. The Queen,*[6] the Supreme Court of Canada held that, in determining whether income is from "property used or held... in the course of carrying on a business" the proper test was whether the property was “employed and risked” in the business. We understand that this may not be the test in applying the LOB under United States tax law.

We understand that, by adopting the LOB to apply in Canada as well as the United States, Canada’s intention is that the same sets of rules should apply in both countries. If that is the case, we submit that existing United States interpretations of undefined expressions in the LOB should also be applied in Canada.

We recommend that the meaning of “in connection with or incidental to” be clarified in the Technical Explanation. In particular, we recommend that it be confirmed whether (and, if so, under what circumstances) dividends, interest or gains derived by an entity in the

[6] 86 DTC 6521

resident country from an affiliated entity in the source country (or from the disposition of an interest in such entity) will be considered to qualify under paragraph 3.

We also recommend that the meaning of "business of making or managing investments" be clarified. Would the term include a business of acquiring and collecting trade receivables or loans?

F. Canadian Compliance Matters

According to the Backgrounder, the Protocol "extends treaty benefits" to LLCs. Unless compliance issues are addressed, many LLCs will have difficulty establishing entitlement to these benefits in actual practice. Similarly, there will be practical compliance issues in determining whether the new LOB applies to deny treaty benefits. We are concerned that, unless these matters are addressed, there will be significant practical difficulties in administering the Convention.

Paragraph 150(1)(a) of the Act requires all non-resident corporations to file a Canadian tax return if Canadian tax under Part I of the Act is or, but for a tax treaty would be, payable by the corporation. Since Canada regards an LLC as a "corporation," this requirement applies to an LLC that is an FTE under United States tax law. Accordingly, if the LLC has business profits from carrying on business in Canada, but does not have a permanent establishment in Canada, we understand the business profits would not be taxable in Canada to the extent that such profits are derived by a member of the LLC which is entitled to the benefit of Article VII of the Convention. As a practical matter, the relevant information to establish entitlement to the treaty benefits under the FTE Relieving Rule may not be readily available to the LLC. Even where an LLC has a single member, it would be necessary for the LLC to determine whether the LOB applies to deny relevant treaty benefits.

Similarly, in order for Canada's withholding tax provisions to work effectively, persons paying dividends (including dividends paid by Canadian public corporations), royalties, management fees or other amounts subject to Canadian withholding tax must be able to determine whether a reduced or zero rate of withholding applies under the Convention. As a practical matter, the information to make this determination may not be available to the payer. In the case of a payment to an LLC or other FTE, it would be necessary to determine whether (and to what extent) the FTE Relieving Rule applies. In all cases, it would be necessary to determine whether the LOB applies to deny treaty benefits to a U.S. payee.

We recommend that a certification procedure be established in order to facilitate the claiming of benefits under the Convention and to protect the Canadian payer from penalties for failure to withhold the correct amounts.[7] We also recommend clarification of the tax-filing obligations of LLCs and other FTEs.

There may be an urgent need for some U.S. persons to apply to the Canadian Competent Authority under paragraph 6 of the LOB for a determination as to their entitlement to treaty

[7] See U.S. form W-8BEN "Certificate of Foreign Status of Beneficial Owner for United States Withholding."

benefits. We recommend that a procedure for such applications be established as soon as possible and that consideration be given to an expedited procedure for U.S. based multinational corporate groups with one or more existing Canadian subsidiaries.