Technical Explanation and U.S. Senate Hearing bring Canada-U.S. Treaty Protocol closer to ratification

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The Canadian and US business and tax communities welcomed the signing last September of a long awaited Protocol to the tax treaty between the two countries (the "Treaty"). The Protocol addresses a wide range of cross border tax matters, including issues affecting financing, intercompany transactions and entities held by U.S. or Canadian investors which are treated as "fiscally transparent" in one but not both jurisdictions (a "hybrid entity").

As well as providing much-welcomed relief, the Protocol raises some new tax barriers - involving cross-border services, hybrid entities, and certain other matters – and its language and approach creates significant uncertainty in certain areas.

The U.S. Treasury Department's "Technical Explanation" of the Protocol released yesterday in conjunction with Senate hearings on the Protocol clarifies at least some of the outstanding issues. The Canadian Department of Finance has announced that it endorses the Technical Explanation. Yesterday's hearings suggest it is unlikely that certain provisions in the Protocol which appeared to trouble the Senate will lead to a delay in Senate ratification or the unusual (but not unprecedented) step of "reserving" on one or more positions of the
Protocol. As Canada has already ratified the Protocol, formal procedures to bring the Protocol into force may be completed soon.

HIGHLIGHTS

The Technical Explanation:

- confirms the effective dates for a three year phase-in of exemption for cross-border related party interest payments.
- holds out the prospect of quick access to mandatory binding arbitration for existing transfer price disputes.
- provides guidance regarding new Treaty benefits for US limited liability companies ("LLCs") and provides comfort for S corps.
- confirms that the existence within corporate groups of LLCs that are fiscally transparent for US tax purposes will not inadvertently trigger new anti-treaty shopping rules.
- holds out the possibility that branches can deduct "notional" expenses.

But the Technical Explanation:

- does not address the inappropriate limitation on benefits for US-owned Canadian unlimited liability companies ("ULCs") under the Protocol.
- does not clarify whether the Protocol will result in higher US branch profits tax on Canadian-owned LLCs that are fiscally transparent for US tax purposes.
- does not completely clarify new look-through rules for US companies to access a 5% rate on Canadian dividends.
- does not moderate potentially overreaching rules for cross-border employment income.

FINANCING

The Protocol eliminates withholding tax on most related party (e.g. intercompany) cross-border interest payments, with a phase-in over three years. The timing of the phase-in is somewhat unclear under the coming into force rules in the Protocol. The Technical Explanation confirms that if the Protocol is ratified this year, the applicable withholding tax rate will be 7% FOR ALL OF this year, 4% for 2009 and nil for 2010 and beyond.

The Protocol also provides an exemption (without phase-in) for most unrelated party interest. This rule has been rendered moot for most interest payments from Canada because Bill C-28, enacted last December, exempts (effective January 1 of this year) most interest
payments to unrelated foreign lenders from the 25% Part XIII tax. This Protocol rule is, however, important for both Canadian banks, which are not eligible for the current US "portfolio interest exemption" -- normally applicable to interest paid by US borrowers -- and persons who own (directly or indirectly) at least 10% of the equity of the borrower. Participating interest is to be subjected to a 15% withholding tax, which is a lower rate than the non-treaty rates in both countries. The Protocol also extends the withholding tax exemption to cross border guarantee fees.

INTERCOMPANY TRANSACTIONS

The Protocol addresses several issues affecting intercompany (or intracompany) transactions. For disputes respecting intercompany transfer pricing, the Protocol provides a binding arbitration facility. This is intended to resolve pricing disputes that have remained outstanding for two years or more despite conventional Mutual Agreement Procedure (MAP) settlement efforts. The Protocol appears to require a two-year delay from the implementation of the Protocol before arbitration can start, even for pre-existing disputes which have not been resolved under MAP. Fortunately, the Technical Explanation provides that arbitration procedures will be implemented as soon as next year. In particular, it states:

"In order to avoid the potential for a large number of MAP cases becoming subject to arbitration immediately upon the expiration of two years from entry into force, the competent authorities are encouraged to develop and implement procedures for arbitration by January 1, 2009, and begin scheduling arbitration of otherwise irresolvable MAP cases in inventory (and meeting the agreed criteria) prior to two years from entry into force."

There is uncertainty for US companies carrying on business in Canada through Canadian branches as to whether a diplomatic note appended to the Protocol adequately addresses any negative inferences arising from the Federal Court of Appeal decision in Cudd Pressure respecting the ability of a Canadian branch to deduct notional or imputed amounts (e.g., rent, royalties or interest) for the use the branch makes of head office property. The Technical Explanation calls for recognizing head office or branch compensation for services performed within the arm’s length pricing standard (illustrated by an example that specifically endorses the use of arm's length charges for head office expenses in lieu of cost allocations). It also goes on to suggest that notional intracompany charges are generally permissible:

"Thus, the Contracting States agree that the notional payments used to compute the profits that are attributable to a permanent establishment will not be taxed as if they were actual payments for purposes of other taxing provisions of the Convention, for example, for purposes of taxing a notional royalty under Article XII (Royalties)."
HYBRID ENTITIES

The Protocol’s provisions respecting hybrid entities are a mixed bag—solving issues for some (mainly, if not only, US) taxpayers in new Treaty Article IV(6) while curtailing certain tax planning of some (mainly, but not only, US) taxpayers in new Treaty Articles IV(7)(a) and (b). There are a number of uncertainties regarding the alleviating rules, and the anti-tax planning rules are overreaching. As a result, the tax community has been awaiting the Technical Explanation to see if it resolves these concerns (although Canadian Government officials have been warning that a further Protocol will be required to fix some of the overbreadth problems).

New Treaty Article IV(7)(b) provides that, commencing as soon as 2010, where US investors hold ULCs that are fiscally transparent for US tax purposes, payments made by such ULCs may not be eligible for treaty benefits. A dividend paid to a US shareholder would be taxed at the rate of 25%, not the Treaty rate of either 5% or 15%. Similarly, interest paid by a fiscally transparent single member ULC to its shareholder would be subject to 25% withholding tax. Royalties paid by such a ULC to a US licensor similarly may be adversely affected. It is less clear how interest or royalties paid by a ULC that is treated as a partnership for US tax purposes will be affected by this rule.

Although this rule apparently is aimed at tax planning that either or both countries considered abusive, its scope clearly is too broad. It is difficult to see any possible abuse where dividend payments, which are not deductible, are involved. Indeed, it is almost equally difficult to see any justification for the rule where interest or royalty payments are involved—particularly in light of certain Spring 2007 US initiatives (involving the dual consolidated loss rules) against tax planning by US-based multinationals.

Unfortunately, but not surprisingly, the Technical Explanation does not address the scope of IV(7)(b). However, the separate explanation of the Protocol, issued July 8 by the Congressional Joint Committee on Taxation, states at page 101 that the Senate Committee may “…wish to inquire whether a rule might have been negotiated in lieu of subparagraph 7(b) that would have more narrowly targeted abusive cross-border structures while at the same time causing less disturbance to non-abusive structures.” And, that explanation notes that restructuring will be required in order to avoid double taxation. The Department of Finance has suggested that the delayed implementation provides an opportunity to revisit this provision before it comes into force in 2010. Meanwhile, these statements may be helpful in arguing against any Canadian anti-treaty shopping initiatives if US groups introduce third-country entities into ULC structures to avoid the consequences of Treaty Article IV(7)(b).

A potential issue for certain Canadian-owned US business interests arises out of another anti-hybrid entity tax planning rule (Treaty Article IV(7)(a)) – a rule mainly aimed at US parties using certain Canadian partnership-based financing structures for their Canadian subsidiaries. The question is whether a Canadian corporation which is engaged in a US business through an LLC that is fiscally transparent for US tax purposes is entitled to a reduction of the US Code's 30% branch profits tax rate to 5% under Article X(6). The
Technical Explanation does not address the issue.

There are a number interpretive issues regarding the Protocol provisions incorporates in Treaty Article IV(6), which allow US members of LLCs that are fiscally transparent for US tax purposes to claim treaty benefits in respect of Canadian source income and gain derived through such LLCs. The Technical Explanation addresses some of these issues. For example, if a US person claims Treaty benefits in respect of Canadian source income earned by an LLC, it will be the LLC which must comply with the Canadian tax filings associated with that claim. The Technical Explanation's detailed discussion of the relationship between the flow-through rule of Treaty Article IV(6), and the requirements under Treaty Articles X, XI and XII, respecting “beneficial ownership” for eligibility for treaty rates thereunder, appears to adequately address initial concerns. The Technical Explanation also indicates that the LLC's permanent establishment will be attributed to the members for purposes of Article VII of the Treaty relating to the taxation of business income. In addition, it indicates that principles developed in US tax regulations are to be applied in determining whether an entity is "fiscally transparent" and therefore entitled to the benefits of new Treaty Article IV(6).

The Technical Explanation continues to endorse the traditional US view that an “S corporation” is fiscally transparent, but states that Canada will ordinarily treat it as a Treaty resident entitled to treaty benefits with respect to Canadian source items of income.

LIMITATION-ON-BENEFITS

"Limitation on Benefits" ("LOB") rules, aimed at countering so-called treaty-shopping, were added to the treaty in 1995, but only by the US. The Protocol amends these provisions and makes them bilateral. In general terms, these rules can operate to deny treaty benefits to any US entity (other than certain publicly-traded US corporations) which otherwise meets the requirements (under the "residency" rules of Treaty Article IV(1)) for treaty benefits in respect of Canadian taxes, if certain ownership tests (and in some cases also a "base-erosion" test) are failed. The mechanical nature of the rules raised the spectre of unfair disqualification, particularly if LLCs or third country entities are in the chain of ownership.

The Technical Explanation alleviates these concerns, however, by permitting a look-through of fiscally transparent entities in the chain of ownership.

The Technical Explanation also states, quite questionably from the Canadian standpoint in light of recent Canadian "treaty shopping" jurisprudence, that apart from the technical LOB rules, both countries consider that general domestic anti-avoidance laws (such as the Canadian General Anti- Avoidance Rule) – which are specifically referred to in this Treaty - infuse every treaty to which the two countries are party with an inherent anti-treaty shopping tool. In particular, the Technical Explanation states:

"The statement of this principle explicitly in the Protocol is not intended to suggest that the principle is not also inherent in other tax conventions concluded by the United States or Canada."
OTHER MATTERS OF NOTE

The Protocol provides rules to assign the right to tax stock option benefits in a unique manner designed to avoid double taxation. The Technical Explanation indicates that this is unprecedented in that a similar provision cannot be found in “…the US Model or the OECD Model, although the issue is discussed in detail in paragraph 12 of the Commentary to Article 15 (Income From Employment) of the OECD Model.”

The Protocol seeks to resolve an uncertainty as to whether a US corporation, which owns an interest in a partnership which, in turn, owns shares of a Canadian corporation, can be considered to own any of those shares for purposes of the 10% of voting share ownership test imposed by Treaty Article X(2)(a) in order to qualify for the reduced 5% rate on dividends paid from Canada. Revised Treaty Article X(2)(a) deems the US corporation to own a portion of the shares owned by the partnership, but does not specify how that determination is to be made where there is more than one class of interests in the partnership. The Technical Explanation contains an example that allocates the ownership of shares held by an LLC to its members based on percentage ownership of the LLC, but does not specifically address the issue of multiple classes of interests. It does make the interesting, and potentially significant, observation that the new look through rule is simply confirmatory of the pre-existing US view. In particular, it states:

"The United States views the new parenthetical (which contains the new look-through rule) as merely a clarification." (parenthetical words added)

Existing Treaty Article XV exempts cross border employment income from source country taxation where the salary expense is not borne by an employer resident in the source country or a source country permanent establishment (of a residence country employer) and the employee spends less than 183 days in a calendar year in the source country. The Protocol narrows this exemption by extending the ambit of the first factor ("borne by"), but in a manner that raises some significant uncertainties. Unfortunately, the Technical Explanation does not resolve these issues, including those arising from the distinction between using an employee to render services and seconding an employee. And it may not be particularly helpful that the Technical Explanation chooses to deal with the issues by simply referring to the notion that "...in certain abusive cases, substance over form principles may be applied to recharacterize an employment relationship as prescribed in paragraph 8 of the Commentary to Article 15 (Income from Employment) of the OECD Model."

The ambit of this exemption has also been narrowed by a separate and controversial extension, by the Protocol, of taxing jurisdiction over services businesses (through new "permanent establishment" deeming rules). Indeed, this issue drew the most pointed questions during the Senate hearings yesterday. The Technical Explanation provides a number of examples and other comments on these provisions but, as in the case of the intractable provisions of new Treaty Article IV(7)(b), there were no grounds for a technical explanation to restrict their scope.
CONCLUDING OBSERVATIONS

It is clear that the Technical Explanation of the Protocol released yesterday will facilitate the interpretation and operation of the Treaty changes contained in the Protocol, although several important issues remain unresolved.

Stepping back, two things may now be said about the overall status of the Protocol. First, based on the limited questioning of Treasury officials at the Senate hearings, the Protocol seems headed for ratification by the US shortly, without reservations. Second, there is the question as to whether the Protocol, overall, serves the interests of Canadian and US cross-border business. Perhaps the answer to this general question is provided by the theme of a written statement by Michael F. Mundaca (Treasury Deputy Assistant Secretary for International Tax Affairs) tabled at yesterday’s Senate hearings relating to the new extended permanent establishment rules noted above: "This rule is broader than the permanent establishment rule in the US Model tax treaty, but was key to achieving an overall agreement that we believe is in the best interests of the United States and US taxpayers." (italics added). The bad will have to be taken with the good.


Text of the Joint Committee on Taxation's explanation of the U.S.-Canada protocol (JCX-57-08) is available at http://www.jct.gov/x-57-08.pdf.


The Protocol, together with the related Backgrounder and Annexes, is available at http://www.fin.gc.ca/news07/07-070e.html.

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