NEW CANADA-US PROTOCOL CONTAINS HYBRID ENTITY SURPRISES

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ABSTRACT
The new fifth protocol to the Canada-US income tax treaty, which was signed on September 21, 2007, includes a number of important changes including, most notably, the elimination of withholding tax on most cross-border interest payments. The fifth protocol also includes provisions intended to clarify the treatment of hybrid entities, such as US limited liability companies and Nova Scotia unlimited liability companies, under the treaty. Unfortunately, the hybrid entity provisions are ambiguous in several respects and raise significant questions. The authors discuss the issues raised by the hybrid entity provisions in the protocol and propose some approaches to interpreting those provisions.

KEYWORDS: TREATY ■ WITHHOLDING TAXES ■ HYBRIDS ■ LLC

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INTRODUCTION

The new fifth protocol (“the protocol”) to the Canada-US income tax treaty, which was signed on September 21, 2007, addresses a number of outstanding issues that have been the subject of a great deal of commentary since the last protocol between the countries was signed in July 1997. One widely anticipated provision addresses the treatment of US limited liability companies (LLCs) that earn Canadian-source income. Although this provision was clearly intended to permit the US-resident members of a US LLC to benefit from treaty relief, it unfortunately includes several ambiguities that will limit its value absent change or at least official clarification. The protocol also includes two rules with delayed effective dates (described below) that target other hybrid entity structures that have been used by some taxpayers to generate double dips, in which a single interest payment triggers deductions in both Canada and the United States, and similar transactions. At least one of those rules came as a complete surprise to practitioners, who may have assumed that the protocol would follow the 2006 US model income tax convention and other recent US treaties in this respect. In any event, the new rules appear to have little impact on modern US inbound tower financings, and they do not directly affect structures that rely exclusively on hybrid securities.

HYBRID ENTITIES

LIMITED LIABILITY COMPANIES

LLCs are generally treated as partnerships for US tax purposes if they have more than one member; otherwise, they are treated as disregarded entities. This default treatment can be changed by a check-the-box election to treat the LLC as a corporation for US tax purposes. In the absence of such an election, the LLC is not subject to US taxation as an entity. Regardless of the US treatment of an LLC, however, the LLC is a hybrid entity that is treated as a taxable corporate entity for Canadian tax

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2 United States, Treasury Department, “United States Model Income Tax Convention of November 15, 2006” and “United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006” (herein referred to as “the US model treaty”).

3 Treas. reg. section 301.7701-3 under the Internal Revenue Code, infra note 5.

4 Ibid.
purposes, resulting in adverse treatment under the existing treaty. The Canada Revenue Agency (CRA) takes the position that an LLC treated as a flowthrough entity in the United States is not a qualifying resident of the United States under article IV(1) of the treaty, since it is not “liable to tax” as required by article IV. This position has prevented US investors from using LLCs for Canadian investments and has required investors who normally operate through LLCs to create special structures for their Canadian investments, including unlimited liability companies (ULCs). The CRA’s position has also created a trap for many an unwary US investor and his or her US tax adviser.

The protocol addresses the issue of LLCs by adding a new article IV(6) to the treaty:

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.

US investors who earn Canadian-source income through an LLC that is a flowthrough entity for US purposes should be treated under article IV(6) as “deriving” the income for the purposes of the treaty because (1) the members of the LLC are treated under US law as deriving the income through the LLC; and (2) by reason of the LLC’s fiscal transparency, the members are treated for US tax purposes in substantially the same manner as if they had earned the income directly.5 It is clear that by treating the LLC’s members as having derived the income, the drafters of the protocol intended to permit them to claim treaty benefits for that income. The official Backgrounder to the protocol released by the Canadian Department of Finance makes this point explicitly:

U.S. investors use an LLC to invest in Canada. The LLC—which Canada views as a corporation but is a flow-through vehicle in the U.S.—earns Canadian-source investment income. Provided the U.S. investors are taxed in the U.S. on the income in the same way as they would be if they had earned it directly, Canada will treat the income as having been paid to a U.S. resident. The reduced withholding tax rates provided in the tax treaty will apply.6

5 Section 702 of the Internal Revenue Code of 1986, as amended (herein referred to as “the Code”). Unless otherwise stated, statutory references in this article are to the Code.
However, the mechanism chosen to achieve this result appears to fall short of the stated goal in two respects. First, under Canadian domestic law, the members of the LLC are not taxable on the income derived by the LLC. Rather, the LLC itself is the taxpayer. Accordingly, it is not sufficient to permit the LLC’s members to claim an exemption or reduction from Canadian taxes without also giving the LLC the ability to benefit from its members’ entitlement to treaty protection. Although the Backgrounder makes it clear that the drafters intended LLCs to be able to benefit from this provision, there is no existing mechanism under Canadian domestic law that permits such a transfer of benefits. By contrast, Treasury regulation section 1.894-1(d) permits the foreign owners of a hybrid entity to claim US treaty benefits in the same situation, and Treasury regulation section 1.1441-6(b)(2) provides a procedure for the hybrid entity to make such a claim—namely, by the use of an intermediary withholding certificate similar to the one used by an ordinary partnership.

Second, eligibility for exemption from or a reduction in withholding taxes under the treaty is generally dependent on the recipient being the beneficial owner of the income rather than having “derived” the income.7 The term “beneficial owner” is not defined in the treaty and should therefore be defined by reference to the domestic laws of the source country (that is, Canada) under article III(2) of the treaty “unless the context otherwise requires.” The term “beneficial owner” does not, however, appear to be defined under Canadian domestic tax law. Moreover, in the one place in which “beneficial owner” is defined under US domestic law, the regulations warn that the term is not being defined for payments of income for which a reduced rate of withholding is claimed under an income tax treaty. The US Treasury Department’s technical explanation to the 2006 US model treaty states that in the absence of a definition in a treaty, the term “beneficial owner” refers to “the person to which the income is attributable under the laws of the source State.”8 Under that approach, the LLC would be treated as the beneficial owner because it is the taxpayer under Canadian domestic law. The problem is that the LLC is not a qualifying resident under article IV(6), and it cannot therefore obtain treaty benefits in its own right. This unfavourable result is clearly contrary to what the drafters intended. An alternative approach is to treat this case as one in which the article III(2) exception applies, since the context indicates that the members of a hybrid entity LLC were intended to be treated as the beneficial owners. Note, in that regard, that the commentary to the OECD model treaty states that “[t]he term ‘beneficial owner’ is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.”9 Thus, the beneficial

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7 See, for example, article X (dividends), article XI (interest), and article XII (royalties).
8 “Model Technical Explanation,” supra note 2, at paragraph 2 of the commentary on article 10. See generally the commentary to article 10 of the US model treaty for a discussion of this issue.
owners should probably be defined, at least in the case of Canada, as the same persons who “derived” the income under article IV.

Another possible approach is to treat the LLC as the beneficial owner of the income, as suggested by the analysis in Treasury’s technical explanation to the US model treaty, but to permit the resident and the beneficial owner to be two different persons. At first blush, this approach also seems to fulfill the intent of the drafters, though it glosses over the language of the treaty, which seems to require that the resident be the beneficial owner (see, for example, article X(2), which states, “[B]ut if a resident of the other Contracting State is the beneficial owner of such dividends, the tax so charged shall not exceed . . . ”).

Is there any way to determine which of these two approaches is correct? Consider a case where an LLC that is treated as a partnership for US purposes receives dividends from a wholly owned Canadian subsidiary. Assume that the LLC has two equal members, one a US C corporation and the other a US individual. Does the portion of the dividends attributable to the ownership share of the C corporation qualify for the 5 percent rate under article X(2)(a)? Under the first approach, the C corporation is treated as the beneficial owner of its proportionate share of the dividend received by the LLC. Article X(2)(a) includes an additional requirement—namely, that the beneficial owner own at least 10 percent of the voting stock of the company paying the dividends. The protocol adds the following clarification to the ownership requirement:

(for this purpose, a company that is a resident of a Contracting State shall be considered to own the voting stock owned by an entity that is considered fiscally transparent under the laws of that State and that is not a resident of the Contracting State of which the company paying the dividends is a resident, in proportion to the company’s ownership interest in that entity).

Thus, under the first approach the ownership requirement should be met by virtue of the parenthetical provision quoted above, since the C corporation that is being treated as the beneficial owner of the income is also considered to own the requisite number of shares. On the other hand, the portion of the dividend payment that is indirectly owned by the individual member of the LLC and is therefore treated as “beneficially owned” by the individual will not qualify for the 5 percent rate (since the beneficial owner is not a corporation) but will qualify for the 15 percent rate.

Under the second approach, it seems even clearer that the requirements of article X(2)(a) are satisfied with respect to the C corporation, since the LLC, which is treated as the beneficial owner of the dividends under the second approach, actually owns the requisite amount of stock in the subsidiary. Under this approach, the parenthetical addition to article X(2)(a) not only was unnecessary but may even lead to an adverse conclusion if the language is read broadly as not treating the fiscally transparent entity as owning the shares. Moreover, under the second approach the 5 percent rate is available not only for the C corporation’s 50 percent share of the dividends, but also for the individual’s proportionate share. Since this approach treats the LLC
rather than its members as the beneficial owner of the dividends (though it looks to the identity of the members to determine whether the dividends were derived by a qualifying resident), the ownership and corporate status requirements of the beneficial owner seem to be met, even for the individual's proportionate share. It seems unlikely that the drafters intended to apply an either/or test under which the 5 percent rate is available if either the entity or the member is a company that has the requisite ownership. Accordingly, the first approach, which treats the owners of the LLC as the beneficial owners of the income, is probably the correct one.

**Subchapter S Corporations**

The protocol may also have reopened a question that was long thought to have been favourably resolved—namely, whether dividends received by a US subchapter S corporation from a Canadian subsidiary qualify for the 5 percent rate under article X(2)(a).10 This favourable treatment (which historically was not extended to LLCs) appears to have been based on the theory that an S corporation is treated as being “subject to tax” under article IV(1) by reason of its residence in the United States, notwithstanding that there is a specific statutory exemption from tax.11

The question is whether new article IV(6) applies to S corporations. S corporations seem to fit literally within the class of hybrid entities to which article IV(6) applies. The shareholder of the S corporation is treated under US law as having derived the income of the S corporation by reason of the S corporation being fiscally transparent, and is treated under section 1366(b) in the same manner as if the shareholder had derived the income directly. If article IV(6) applies, then the shareholder rather than the S corporation will be treated as deriving the income. In that case, the parenthetical language in article X(2)(a) will also apply and will prevent the shareholder of the S corporation from qualifying for the 5 percent rate on any subsidiary dividends. (Under section 1361, only individuals are permitted to be shareholders of an S corporation.) Perhaps article IV(6) should be understood as applying only to an entity that is not itself a qualifying treaty resident, although the language of the paragraph is not so limited.

**Payments Received by a Domestic Reverse Hybrid Entity**

Article IV(6) explicitly does not apply if the hybrid entity is a resident of the source state. Thus, if a US investor holds its shares in a Canadian subsidiary through a Nova Scotia unlimited liability company (NSULC), dividend payments received by the NSULC are not eligible for any treaty benefits, notwithstanding that the dividends are treated as having been earned by the NSULC’s US shareholder for US tax


11 For a discussion of this type of approach, see paragraphs 8.2 and 8.3 of the commentary to article 4 of the OECD model treaty, supra note 9.
purposes. (This rule is different from the rule in new article IV(7)(b), described below, which addresses payments made by the NSULC to the US shareholder rather than payments made to the NSULC.) The exclusion for such domestic reverse hybrid entities is not unexpected. The US Treasury regulations under section 894(c) currently include the same rule in the US inbound context.12

**New Article IV(7)**

New article IV(7)(a) contains a rule that is the converse of the rule in article IV(6).

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.

In other words, an item of income is not treated as derived by a treaty resident if it is derived by the resident through an entity that is not resident in the same country as its owner(s) (the entity could be resident either in the source country or in a third country) and that is not treated as fiscally transparent in the owner’s country of residence. This applies, for example, where a US resident earns Canadian-source income through a reverse hybrid Canadian limited partnership that has filed an election to be treated as a (Canadian) corporation for US tax purposes. Since the US resident is not treated as earning the income earned by the limited partnership for US tax purposes, paragraph 7 will deny treaty benefits. This rule may be novel to Canadian readers, but US practitioners will no doubt recognize this approach as the current law in the United States under the section 894(c) Treasury regulations.13

Essentially, new articles IV(6) and IV(7)(a) can be thought of as two aspects of a single rule—namely, that the determination of whether income derived through an entity is treated as derived by a treaty resident is made under the entity classification rules of the country of residence rather than the country of source. Viewed in this way, the rule appears to be a logical extension of the principle in article IV(1) that residence status for treaty purposes is dependent on the tax treatment in the country of residence.

**Payments Made by a Domestic Reverse Hybrid Entity**

Article IV(7)(b) is a completely new rule that took practitioners by surprise. The rule states that income is not treated as derived by a resident of a contracting state where

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12 Treas. reg. section 1.894-1(d)(2)(i).
13 Treas. reg. section 1.894-1(d)(1).
(b) [t]he 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.

This rule applies to dividends paid by a ULC that is treated as a flowthrough entity for US tax purposes to its US shareholders. The rule prevents such dividends from qualifying for a reduction in Canadian withholding tax rates. What is surprising about this rule is that the section 894(c) regulations, which extensively address the various possibilities for treaty abuse that arise from the use of hybrid and reverse hybrid entities, would permit treaty benefits in this situation (that is, in the absence of new article IV(7)(b)). In fact, Treasury specifically considered the possibility of abuse in the context of such payments by a domestic reverse hybrid entity and concluded that treaty benefits should generally be available for such payments, subject to a narrow exception for payments made to a related party that are deductible in the source country where the underlying income earned by the domestic reverse hybrid is treated as a dividend in the country of residence. We understand that article IV(7)(b) was included at the request of the Canadian government and was intended to prevent certain double-dip financing structures that utilize a ULC. However, the CRA may not have realized the scope of the provision, which in its current form will prevent US taxpayers from utilizing ULCs in a broad range of ordinary operating and holding company structures in which double dips and aggressive tax planning play no part.

**Impact on Cross-Border Double Dips**

The amendments in the protocol to article IV(7) of the treaty will have a very significant impact on the use of double-dip structures. This is especially true for Canadian inbound financing structures, which were already under attack as a result of recent amendments to the US dual consolidated loss regulations, under which an “indirect use” of a loss to offset the income of another entity through a hybrid entity or hybrid instrument is effectively disallowed as a deduction to the US participant. One commonly utilized structure involved a US corporation making an equity investment into a Canadian limited partnership that elected to be treated as a corporation for US tax purposes. The Canadian LP then lent the contributed funds to a related Canadian operating company. Interest payments on the debt were deducted in Canada by the operating company and were not subject to income tax in the hands of the lender, since the lender was a limited partnership owned by non-Canadian-resident

16 As noted above, a double dip is a structure in which an interest deduction is generated in both Canada and the United States as result of a single payment.
partners. From a US tax perspective, the interest payments were treated as having been made to a second Canadian corporation and thus were not subject to current US taxation. The interest payments to the limited partnership were subject to Canadian withholding tax; but as long as the treaty applied to reduce the withholding tax rate to 10 percent, the income tax benefit outweighed the cost of the withholding tax (which was also ultimately creditable in the United States). When article IV(7)(a) goes into effect (as described below), this structure will no longer be viable, since the withholding tax rate will increase to the 25 percent Canadian statutory withholding tax rate in the absence of treaty benefits.

Other common Canadian inbound financing structures utilize a loan made by the US investor to a ULC, which makes another loan to the Canadian operating company coupled with a forward share subscription agreement that permits the loan to be treated as equity for US tax purposes. The Canadian operating company claims a deduction for the interest paid to the ULC, and the ULC, in turn, deducts the interest accruing to the US investor. For US tax purposes, the interest may be characterized as a dividend (or ignored, if it is paid in kind). This structure and others like it will no longer be viable under new article IV(7)(b), which will subject the payments made by the ULC to the US lender to Canadian withholding tax unreduced by any treaty benefits.

The amendments will have a lesser impact on the efficiency of tower financing structures from Canada into the United States. Tower structures utilize a US limited partnership that elects to be treated as a corporation for US purposes, which brings the structures squarely within the ambit of article IV(7)(b). However, the US limited partnership is typically financed by a direct loan from a third-party lender. Payments on the third-party loan will not be affected by article IV(7)(b), since the treatment of the lender is not affected by the status of the limited partnership as a corporation for US tax purposes. Moreover, the lender will typically be US-based in any event. Accordingly, the treaty will affect the treatment of the (typically relatively nominal) profits of the US limited partnership only when those profits are distributed to the Canadian owners of the limited partnership. Note that as a result of proposed section 18.2 of the October 2007 legislative proposals, tower structures will largely cease to be of any benefit to Canadian taxpayers beginning in 2012.

17 Subpart F income was avoided under either the section 954(c)(3) same-country exception or the broader section 954(c)(6) exception for payments received from related controlled foreign corporations that earn active income.
18 Under the proposed section 901 technical taxpayer rules, the withholding tax credit cannot be claimed by the US partner (even though for Canadian purposes the tax is imposed on the US partner’s distributive share of the partnership’s income) until the associated income is distributed by the limited partnership to the US partner. Prop. Treas. reg. section 1.901-2(f), REG-124152-06, 2006-36 IRB 368.
19 See Internal Revenue Service, Chief Counsel Advice AM-2006-1, September 7, 2006, TNT 189-22.
20 Canada, Department of Finance, Legislative Proposals and Explanatory Notes To Implement Remaining Budget 2007 Tax Measures (Ottawa: Department of Finance, October 2007), clause 3.
DIVIDEND WITHHOLDING RATES

The US government, despite support from business interests in Canada, was unsuccessful in seeking to persuade Canada to include a full exemption for subsidiary dividends. The withholding rate for such dividends remains unchanged at 5 percent. The protocol includes expanded benefits for dividends paid by a US real estate investment trust (REIT). Under the current treaty, a rate reduction (to 15 percent) is available only for individual shareholders who own not more than 10 percent of the REIT’s outstanding shares. Under the protocol, the 15 percent rate will also be available to non-individual shareholders that own 5 percent or less of a class of regularly traded shares. Such shareholders currently receive favourable treatment under US domestic law in several respects—namely, an exemption from US taxation under FIRPTA (the Foreign Investment in Real Property Tax Act of 1980) of gain from the sale of the REIT’s shares and an exemption from tax on capital gain distributions by the REIT attributable to proceeds from the disposition by the REIT of US real property interests. The 15 percent rate will also be available for non-publicly traded shares in a diversified REIT if the corporate shareholder holds 10 percent or less of the REIT’s shares.

INTEREST WITHHOLDING TAX RATES

The protocol goes much further with respect to interest than with respect to dividends and will completely eliminate withholding tax on most interest payments. This is especially good news for Canadian banks, which do not qualify for the portfolio interest exemption from US withholding tax on interest payments that is available under US domestic law to most unrelated borrowers. Also of great significance is the elimination of US and Canadian withholding tax on interest payments made to related-party lenders, which are not currently eligible for the US portfolio interest exemption or the Canadian 5/25 exemption. For related parties, however, the exemption will be phased in over a two-year period, dropping to 7 percent in the first year that ends after the protocol enters into force (which is likely to be 2008), to 4 percent in the second year, and to zero thereafter.

The withholding tax exemption will not be available to interest that is dependent on the receipts, sales, income, profits, or cash flow of the borrower or a related person or on dividends or partnership distributions made by the borrower or a related person. (This same limitation currently exists as an exception to the US portfolio interest exemption.) Instead, contingent interest payments will be treated in the same way as (non-subsidiary) dividends under the treaty and subjected to a 15 percent withholding tax.

21 Article 6 of the protocol.
22 Article 27(3)(d) of the protocol.
OTHER PROVISIONS
Royalties
Disappointingly, the 10 percent withholding tax on trade name and trademark royalties will not be eliminated by the protocol.

Limitation-on-Benefits Provision
The protocol will extend the specific article XXIX A limitation-on-benefits anti-treaty-shopping rules contained in the existing treaty to US residents seeking to claim treaty benefits on Canadian-source income. Currently, these rules apply only to Canadian residents claiming treaty benefits in the United States. The specific rules in the treaty should supplant the Canadian domestic general anti-avoidance rules, which Canada currently relies upon to police treaty shopping.

Arbitration of Disputes
The protocol includes a new taxpayer right to arbitration of disputes over treaty interpretation in cases where the competent authorities are unable to reach a complete agreement. This right is limited to matters of the types agreed to by the United States and Canada in diplomatic notes under the treaty. In conjunction with the signing of the protocol, diplomatic notes were exchanged to confirm that disputes involving the following matters will be eligible for arbitration: (1) the determination of the residence of a natural person under article IV; (2) the existence of a permanent establishment under article V; (3) the attribution of business profits to a permanent establishment under article VII; (4) transfer-pricing disputes under article IX; (5) transfer-pricing issues involving royalties subject to article XII or the classification of a royalty as exempt from withholding tax; and (6) any other matter that the competent authorities agree to on an ad hoc basis. The inclusion of transfer-pricing matters will be especially helpful to taxpayers.

Employee Benefits
The protocol includes detailed new rules dealing with pension fund contributions and accruals. There is also a provision to eliminate the double taxation of stock option benefits.

Corporate Continuances
The protocol clarifies that a corporation that is continued from one country to another without being discontinued in its state of origin will, in the absence of a competent authority determination, be denied treaty benefits.23

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23 New article IV(3), added by article 2 of the protocol.
EFFECTIVE DATES

The protocol must be ratified by both the United States and Canada before it goes into force. The protocol will go into force on the later of the date on which ratification is completed and January 1, 2008.\textsuperscript{24} At least in the case of the United States, it seems unlikely that ratification will occur before the end of 2007. Once the protocol goes into force, it will generally be effective with respect to withholding taxes almost immediately, on amounts paid on or after the first day of the second month that begins after the date on which the protocol enters into force (no earlier than March 1, 2008).\textsuperscript{25} With respect to other taxes, the protocol will generally be effective in the first taxable year that begins after the protocol enters into force (probably in 2009 for calendar-year taxpayers) unless ratification occurs in 2007 (in which case it will be effective for such taxes in 2008, the same year it goes into force).\textsuperscript{26}

Notwithstanding these general effective dates, there are several special effective dates for particular provisions. Specifically, the new rules in article IV(7) (which limit treaty benefits for certain hybrid entity structures), but not the new favourable LLC rule in article IV(6), are delayed until the first day of the third calendar year that ends after the treaty goes into force.\textsuperscript{27} In other words, assuming that the treaty goes into force during 2008, article IV(7) will go into effect on January 1, 2010. On the other hand, the effective date for the new taxpayer arbitration rights is accelerated and applies to cases arising on or after the date on which the protocol enters into force, even if the underlying item pre-dates the protocol.\textsuperscript{28} Finally, as mentioned above, the elimination of withholding tax on interest received from related parties is phased in over three years.\textsuperscript{29}

\begin{itemize}
\item[24] Article 27(2) of the protocol.
\item[25] Article 27(2)(a) of the protocol.
\item[26] Article 27(2)(b) of the protocol.
\item[27] Article 27(3)(b) of the protocol.
\item[28] Article 27(3)(f) of the protocol.
\item[29] Article 27(3)(d) of the protocol.
\end{itemize}