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LETTERS TO THE EDITOR

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To the Editor:

Lee Sheppard (''Treasury Feels Pain of Canadian Protocol,'' *Tax Notes Int'l*, Oct. 27, 2008, p. 266, *Doc 2008-22399*, or *2008 WTD 206-8*) rightly notes that the new antiavoidance provisions respecting cross-border hybrids, to be added as Article IV(7)(b) to the Canada-U.S. Income Tax Convention by the Fifth Protocol (signed in September 2007), have been roundly criticized as imposing inappropriate and punitive overall tax effects for U.S. parties carrying on business in Canada through some Canadian-formed hybrids. These are unlimited liability companies (ULCs) that can be formed under the laws of Alberta, British Columbia, and Nova Scotia, and which are treated as corporations for Canadian tax purposes, but generally as flow-through partnerships (when there is more than one owner) or total ''disregards'' (when there is only one owner) for U.S. tax purposes.

In these circumstances, new Article IV(7)(b) may operate to deny treaty benefits (regarding Canadian taxes otherwise arising) for payments made by the ULC to a U.S. party, particularly one that owns the ULC. Sheppard notes that ''[T]axpayers and Senate Foreign Relations Committee member Robert Menendez, D-N.J., have asked Treasury to renegotiate paragraph 7,'' and then goes on to discuss views expressed on this matter by Michael Mundaca, Treasury's Deputy Assistant Secretary for International Tax Affairs, at an October 21, 2008, presentation that Mundaca and Kim Blanchard, of Weil Gotshal, made to the International Tax Institute.

The problem, however, is that certain significant misleading aspects of Sheppard's discussion, of an already difficult area, may exacerbate the situation. The most glaring is the incorrect blanket assertion that interest paid by a ULC out of interest earned by the ULC will not be caught by this rule. Sheppard writes, ''[I]f the hybrid [the ULC] had earned interest and had paid interest to its U.S. owners, there would be no problem under paragraph 7(b), because the payment would not have changed character by reason of being paid from the hybrid. Treaty benefits would be forthcoming.'' The reference to not having ''changed character'' is Sheppard's proxy for that aspect of the rule that requires (for the rule to apply) that ''the treatment of 'the amount' under the taxation law of that state (for example, the United States) is not the same as its treatment would be if that entity were not treated as fiscally transparent under the laws of that state.''

Sheppard's conclusion is wrong when the ULC is owned by one U.S. person and is therefore a disregard under the Code. In those circumstances, the interest payment by the ULC is as disregarded as the ULC itself, for U.S. tax purposes, and the rule of Article IV(7)(b) is squarely engaged.

If, however, there are two or more owners, such that the ULC is treated as a partnership for U.S. tax purposes, then the condition is not met and the rule does not apply. This is because the Code recognizes an interest payment by a partnership to a partner. And both of these opposing results and conclusions are recognized by Blanchard and Mundaca in their October 21 slide presentation to the ITI. In particular, at slide/page 17 they define, for purposes of their presentation, an ''Outbound Regular Hybrid'' as being: ''US owner, Canadian entity treated as FTE [fiscally transparent entity] in the US, but as corporation in Canada,'' and then at slide/page 25, they depict such a hybrid as making a ''relevant payment'' to a wholly-owning U.S. person with the following comment: ''Here, there is a payment by the hybrid. Note that if the hybrid is a partnership and the payment is one of interest, 7(b) should not apply as the US sees interest income whether the payor is a partnership or a corporation.''

Somewhat ironically, Sheppard then goes on to deal with the just-noted benign results when there is more than one owner of a ULC, but in a fashion that contains a second significant misunderstanding of the rules. Sheppard writes, ''[T]axpayers can engage in self-help. They can get another investor and make the disregarded entity into a partnership. [So far, so good.] That way, the distributions of income would be covered by paragraph 6 of Article IV, under which the Canadians accept the U.S. view of treaty benefit for investors in pass-through entities.'' But this cannot be correct because Article IV(6) — which is intended to ameliorate and solve the Canadian treaty benefit issue for U.S. persons earning Canadian-source income through *U.S.* flow-through entities, most notably U.S. limited-liability companies — cannot on its face apply in any fashion to income earned by or through a resident of Canada such as a ULC.

In particular, Article IV(6) specifically requires the earning of income by ''an entity (other than an entity that is a resident of the other Contracting State)'' — and in this context, when a U.S. person is seeking treaty benefits from Canada, that ''other contracting state'' is Canada. Finally, in this respect, there is nothing in slide/page 25 of the Mundaca-Blanchard presentation that connects the discussion to Article IV(6).

Perhaps at the end of the day these significantly inaccurate comments by Sheppard are simply further evidence of why the two countries should negotiate, as quickly as possible, another protocol to abolish Article IV(7)(b). Finally, the Fifth Protocol is expected to be brought into force before the end of this year because both countries have completed internal approval procedures and only an ''exchange of instruments of ratification'' is required; and to that extent this inappropriate rule would have effect beginning January 1, 2010. That should give the parties enough time to renegotiate this rule — n'est-ce pas? ◆

Yours sincerely,

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