

International Fiscal Association (IFA) Conference  
Canada Revenue Agency Roundtable  
May 19, 2011

Slides 4, 5 and 6 - Characterization of Foreign Entities  
Application of treaties to partnerships and their members

#### Question One

Historically, when applying treaty benefits to a partnership and/or its members, the CRA has generally looked through the partnership and applied any applicable treaty benefits at the member level. With limited exceptions, the CRA has followed this approach regardless of whether the partnership was subject to entity-level taxation in a country other than Canada (i.e., a hybrid partnership). In a technical interpretation released in early 2004, the CRA indicated it was reviewing its position, at least in situations where the partnership was formed in Canada, had US-resident partners and has elected under the *Internal Revenue Code* to be taxed as a corporation for US income tax purposes. The existence of this review was confirmed by the CRA at the International Fiscal Association's 2004 Canadian Branch Seminar in Montréal, and the CRA indicated that it would announce the results of its review in an issue of the *Income Tax Technical News*. To date, there has been no such announcement.

Can you provide an update on the ongoing review of the treatment of Canadian partnerships with US partners that have elected for US tax purposes to be taxed as corporations?

#### Response

For a number of years, the CRA reviewed the issue of whether treaty benefits should apply to Canadian-source income derived by US-residents through partnerships that were treated as foreign corporations for US tax purposes. Prior to the review, the CRA's position was that the members of entities which constituted partnerships for Canadian tax purposes would ordinarily be considered the beneficial owners of income earned by or received by a partnership. It followed that treaty benefits could apply in respect of the members' share of the partnership's Canadian-source income.

Under an arrangement typically referred to as a "synthetic NRO", US-residents could form a partnership under Canadian partnership law and elect to treat the partnership as a corporation for United States tax purposes. The partnership would then loan funds on an interest-bearing basis to a Canadian-resident subsidiary corporation. Subject to US controlled foreign corporation and passive foreign investment corporation regimes, the interest income on the loan would not be taxed in the hands of the US-resident partners until the partnership distributed its earnings to those partners. Applying the position described in the preceding paragraph, the US-resident members would be considered the beneficial owners of any interest income paid to the partnership by the Canadian-resident subsidiary, such that the rate of Part XIII withholding tax on the interest payments would

be reduced to 10% under Article XI of the Canada-United States Income Tax Convention (the “Convention”).

This arrangement was structured so that the Canadian-resident subsidiary would be able to deduct the interest in computing its income under the Act. Taken as a whole, it resulted in an interest deduction for Canadian tax purposes without an immediate offsetting interest income inclusion for United States tax purposes.

In 2000, paragraph 6.2 was added to the commentary to Article 1 of the OECD Model Tax Convention on Income and on Capital (the “OECD Model”). The comments in that paragraph called into question whether treaty benefits should apply to the Canadian-source income of the partnership (i.e., the interest payments made to the partnership by the Canadian-resident subsidiary) since the members of the partnership did not recognize the Canadian-source interest income for US tax purposes. Given the conflict between the OECD Model commentary and the CRA’s position, the CRA initiated the review of the existing position on the application of treaty benefits to income of partnerships formed in Canada that were treated as foreign corporations under US tax laws.

The review commenced in 2003. The matter remained under consideration until the Fifth Protocol to the Convention was signed on September 21, 2007, at which time Article IV(7)(a) was added to the Convention. As a result of the introduction of Article IV(7)(a) to the Convention, the review was suspended.

The provision, which has effect from January 1, 2010, effectively denies treaty benefits under the Convention in respect of income that would otherwise be considered to be derived by US residents through entities that are fiscally transparent for Canadian tax purposes, such as a partnership formed under Canadian laws that has elected to be treated as a foreign corporation for US tax purposes. Treaty benefits will be denied if the partnership’s lack of fiscal transparency for US tax purposes causes the income to be treated differently, vis-à-vis the US-resident member for US tax purposes, than would be the case if the income were derived by the US-resident member directly. Article IV(7)(a) explicitly adopts the approach suggested in paragraph 6.2 of the commentary to Article 1 of the OECD Model, which, as discussed above, was the source of conflict giving rise to the review of the CRA’s position.

In cases where Article IV(7)(a) (or a similar treaty provision, if any) does not apply, the CRA will continue to apply the position which preceded the review. In other words, treaty benefits will continue to apply in respect of Canadian-source income that a member of a partnership is considered, under Canadian tax law, to derive through an entity that is a partnership for Canadian tax purposes, to the extent the member is otherwise eligible to claim such benefits under the terms of the tax treaty between Canada and the member’s jurisdiction of residence.

## Question Two

In 2008, the CRA was asked whether a “US partnership”, presumably formed under United States partnership law and treated as a corporation for the purposes of the IRS Code (and therefore subject to US income taxes on its worldwide income), would, itself, be eligible for benefits under the Convention, or whether, in such circumstances, the CRA would continue to assess treaty benefits at the member level.

In response to this question, the CRA indicated that, provided section 6.2 of the *Income Tax Conventions Interpretation Act* (Canada) did not apply, it would treat the US partnership as a US resident for the purposes of the Convention and would apply the limitation on benefits article (Article XXIX A) at the partnership level. On that basis, the CRA went on to say that the members could claim treaty benefits based on the US partnership’s eligibility for benefits under the Convention.

The CRA’s response to the questions posed in 2008 is unclear. On one hand, the CRA has indicated that, provided certain conditions are satisfied, it will apply the Convention to the US partnership, but on the other hand, the CRA indicated that it would be the members of the US partnership (and not the partnership itself) that would actually claim the treaty benefits. Please clarify your earlier comments concerning the treatment of the US partnership as a US resident under the Convention, application of limitation on benefits article, and ability of the partners to claim treaty benefits based on the partnership’s eligibility for treaty benefits. How are partners not resident in the US treated under this approach?

## Response

From a Canadian tax perspective, a partnership that is a US resident under the Convention (because of its election to be a domestic corporation under the Code) remains a partnership for the purposes of the Act. This means that the members of the partnership are the taxpayers considered to derive any Canadian-source income earned by the partnership under Part I. Though paragraph 212(13.1)(b) of the Act deems a partnership that is not a Canadian partnership to be a non-resident person in respect of a payment of a Part XIII income amount, we still consider the members of the partnership to be the relevant taxpayers for the purpose of assessing the degree to which treaty benefits apply to the income payment.

Under this approach, a US-resident member of a US partnership that earns or receives Canadian-source income can claim either the treaty benefits that would be provided to the member under the Convention, or the treaty benefits that apply to the US partnership (if the US partnership is a US resident corporation under the Convention) in respect of the member’s share of the income amount. A member of the partnership who is not entitled to claim treaty benefits under the Convention (i.e., a resident of a third country) can claim, in respect of its share of the income amount, either the treaty benefits that would be provided to the member under another tax treaty, or the treaty benefits that apply to the US partnership. In effect, the member will be permitted to choose between

the treaty benefits at the member level and those available at the partnership level, so that the member can claim the more favourable treaty benefit.

To illustrate this approach, assume that all of the issued and outstanding shares of a Canadian-resident corporation are held by a partnership formed under US partnership laws. The partnership has elected under the Code to be treated as a US-resident corporation. The partnership has three partners entitled to equal shares of the partnership's income: Pubco, a publicly-traded US domestic corporation, Fund, a US "Article XXI" tax-exempt entity, and Mr. B, a Bermuda-resident individual. The partnership directly carries on active business activities in the United States (assuming that the tax-exempt entity would be permitted to be a member of the particular partnership under the Code without adverse US tax consequences), which are identical in nature to the business activities carried on in Canada by the Canadian-resident subsidiary corporation.

If the Canadian-resident subsidiary paid a dividend of \$300 to the partnership, each member would be considered to receive Canadian-source dividend income of \$100. The treaty benefits that applicable to each member of the partnership would be as follows:

- (a) Pubco could either claim treaty benefits under Article X(2)(b) in respect of its share of the dividend, with a resulting 15% Part XIII liability, or claim partnership-level treaty benefits under Article X(2)(a) (since the partnership holds all of the voting stock of the subsidiary) of the Convention in respect of that share of income. Pubco would clearly prefer the later, so the Part XIII dividend withholding tax applicable to Pubco's share would be \$5.
- (b) Fund could either claim its Article XXI exemption on the dividend income or claim partnership-level treaty benefits under Article X(2)(a) of the Convention in respect of that share of income. Fund would clearly prefer the exemption, so Part XIII dividend withholding tax would not be exigible in respect of Fund's share of the dividend.
- (c) Mr. B cannot claim treaty benefits on his own accord since he is not resident in a country with which Canada has concluded an income tax treaty, but he can still claim partnership-level treaty benefits under Article X(2)(a). Mr. B would clearly prefer the lower treaty rate, so the Part XIII dividend withholding tax applicable to his share would be \$5.

Although a US partnership can be a US resident under the Convention, any resulting entitlement to treaty benefits is subject to the limitation on benefits article in Article XXIX A. In our view, while a partnership that has elected to be a domestic corporation is considered a company within the meaning of Article III(1)(f) of the Convention, it will generally not be a "qualifying person", as defined in Article XXIX A(2) due to the absence of share capital in a partnership. For the same reason, treaty

benefits are not allowed to the partnership under the “derivative benefits” test in Article XXIX A(4).

Consequently, partnership-level treaty benefits may only apply to Canadian-source income of the US partnership in accordance with the “active trade or business” test under Article XXIX A(3) or if treaty benefits are granted by the Canadian competent authority under Article XXIX A(6). In applying the test in Article XXIX A(3) to a US partnership’s claim for treaty benefits in respect of Canadian-source income, we have determined that the trade or business activity of a subsidiary of the partnership is not a trade or business of a related person because a partnership is, as a general matter, not a person for Canadian tax purposes and therefore cannot be related to its subsidiary for the purposes of this test.

### Question Three

Do the answers to the above questions depend on whether the partnership is organized under the laws of a Canadian province or of a foreign jurisdiction? Does your approach depend on the particulars of the applicable partnership law? In this regard, the CRA has previously granted treaty benefits to partnership-like entities that also had characteristics similar to those of a corporation

### Response

Our understanding is that for US tax purposes, the jurisdiction under which a partnership is formed determines whether it is a domestic entity or a foreign entity (i.e., a place of incorporation test). Consequently, it appears that a partnership formed under Canadian partnership law would be a foreign entity for US tax purposes so if that partnership elected to be an association (and thereby a corporation) for US tax purposes, the partnership would be a foreign corporation. On the other hand, if the partnership was formed under US partnership law and elected to be an association for US tax purposes, it would be considered a domestic corporation. It is our understanding that only partnerships treated as domestic corporations would be residents of the United States under the Code. Therefore, the organization of the partnership is relevant since (i) it can determine whether the partnership could be considered a resident of the United States under the Convention and (ii) Article IV(7)(a) may preclude entitlement to treaty benefits if US residents held interest in partnerships formed outside of the US.

While we acknowledge that there are other countries in which partnerships are treated as corporations for domestic tax purposes, we are not aware whether the residency of such partnerships is determined with reference to the jurisdiction under which the partnership was formed.

In determining whether members of a partnership can claim treaty benefits in respect of Canadian-source partnership income, it is necessary to consider of the relevant commercial laws to determine whether the entity is a partnership or another type of entity

for Canadian tax purposes. If a review of the governing law leads to the conclusion that the entity is a corporation and not a partnership, then the entity is treated as such for the purposes of determining whether treaty benefits apply and the “partners” of the entity cannot obtain treaty benefits on their own accord since they will not be considered to derive or receive the Canadian-source income through the entity, unless a provision like Article IV(6) of the US Treaty applies to deem that such income is derived by the partner.

#### Question Four

Does the CRA provide rulings on foreign entity characterization?

#### Response

The CRA has discontinued the practice of providing advance income tax rulings to explicitly confirm whether an entity established under foreign laws constitutes a partnership, corporation, trust or other arrangement (such as an unincorporated association or co-ownership arrangement) for the purposes of the Act. Paragraph 15(k) of Information Circular IC 70-6R5, “Advance Income Tax Rulings” dated May 17, 2002, states that the CRA may refuse to issue an advance tax ruling where an issue would require an opinion or interpretation of foreign law.

The CRA generally approaches the question of foreign entity characterization by (i) determining the characteristics of the foreign business association under foreign commercial law and (ii) comparing these characteristics with those of recognized categories of business associations under Canadian commercial law in order to classify the foreign entity under one of those categories. This approach to classification necessarily involves a high degree of interpretation of foreign laws.

Instead of providing advance tax rulings which explicitly address the characterization of the foreign entity, the CRA is prepared to provide rulings on the application of the provisions of the Act that are dependent on the characterization, provided that the party requesting the ruling provides a factual representation of the entity’s classification for Canadian tax purposes and adequately discloses the foreign law which governs the entity. If there no apparent reason to dispute the characterization of the entity represented in the ruling request based on the foreign laws disclosed therein, we can proceed to consider the requested rulings. If a ruling is issued, the classification of the entity is subject to further review when the transactions covered in the ruling come under audit, but we would not ordinarily expect the entity’s characterization to be challenged under the audit process unless there was information available at the time the ruling was under consideration which contradicts the party’s representation of the entity’s classification and this information was not disclosed in the course of reviewing the ruling request.

## Slide 14 - Share Premiums and Foreign Affiliates

### Question

Could the CRA confirm that its current position with respect to distributions of share premiums of a foreign affiliate is accurately reflected in Technical Interpretation E 2004-006013117 dated October 24, 2004) such that the distribution would be characterized as a return of capital and not a dividend or a subsection 15(1) inclusion. Seemingly, CRA's view was that as a result of the amendments to subsection 15(1) in 1988 which narrowed the exclusion from "reduction of capital" to "reduction of the paid-up capital", distributions from foreign corporations that were neither a dividend nor a reduction of paid-up capital would fall into 15(1). The 1988 Technical Notes do not really address the change.

In many cases the distribution would be, in part, a reduction of the equivalent of paid-up capital (e.g., registered capital, nominal capital, par value, depending on the jurisdiction), but would also be a reduction of so called paid-in capital (effectively contributed surplus). As a matter of corporate law in the foreign country, it is a reduction of capital (but not a reduction of paid-up capital *per se*) and not a dividend.

### Response

The technical interpretation referred to above does not stand for the proposition that the distribution would not give rise to a subsection 15(1) benefit. In fact, the conclusion in E 2004-006013117 was that the distribution did not constitute a dividend or a return of paid-up capital under paragraph 53(2)(b), which does not preclude consideration of the application of subsection 15(1) in such instances.

This conclusion is consistent with the position taken in E 2003-0031585, dated August 25, 2003, in which a return of contributed surplus that arose on the issuance of par value shares of a Canadian corporation, that was legally neither a dividend under the relevant foreign corporate law nor a return of paid-up capital, was required to be included in computing the shareholder's income under subsection 15(1).

In such situations, our concern is that a distribution out of paid-in capital that is not legally a dividend under the relevant foreign corporate law could otherwise be repatriated without any tax consequences, and, in particular, without a reduction of the adjusted cost base of the shares, as the distributed amount would not be a return of paid-up capital within the meaning of paragraph 53(2)(b) of the Act.

### Addendum

To clarify the comments initially delivered at the 2011 IFA Seminar, in our view, the better approach for determining the character of a distribution from a foreign corporation to a shareholder for Canadian tax purposes is the same two-step approach that is used for the classification of foreign entities for Canadian tax purposes as set out in

Income Tax Technical News #38. That is, the first step is to determine the characteristics of the distribution under foreign corporate law (not tax law), and then compare these characteristics with those of recognized categories of distributions under Canadian common law and corporate law in order to classify the distribution under one of those categories. This view is a slight change from the view that was expressed in E 2004-0060131I7 where we said that the characterization of the distribution under foreign corporate law will generally be determinative for purposes of the Act.

However, the nature of a distribution under the foreign corporate law may contain nuances that do not exist in Canadian law. Therefore, as a practical matter, the CRA will adopt the following general guidelines:

- Where the distribution is a dividend or a return of legal capital under the foreign corporate law, that characterization will generally not be challenged by the CRA.
- Where the distribution is not a dividend or a return of legal capital under foreign corporate law, the distribution will be considered to be a dividend for purposes of the Act if it meets the basic common law requirements to be a dividend, such as being a pro rata distribution among shareholders of a particular class or series of shares.
- If the August 19, 2011 amendments are enacted as proposed, a pro-rata distribution after August 19, 2011 made by a foreign affiliate as described in new subsection 90(2) will be deemed to be a dividend. Taxpayers may also choose to apply a slightly modified version of new subsection 90(2) to a pro-rata distribution made by a foreign affiliate after February 27, 2004 and before August 20, 2011.
- Subsection 15(1) may apply if the distribution is not otherwise described above and is not described within one of the exceptions described in subsection 15(1).

## Slide 15 - Canadian Branches of LLCs

### Question

Can you comment on your current views with respect to the application of the 5% treaty branch tax rate where US-resident individuals hold an LLC with a Canadian branch, in light of the Tax Court of Canada decision in *TD Securities (USA) LLC v. The Queen*? The view that a 25% statutory rate should apply (due to the inapplicability of treaty relief) is difficult to reconcile with *TD Securities* and the availability of treaty relief to partnerships and S-corps.

### Response

For taxation years in which the Fifth Protocol to the Canada-United States Tax Convention (the “Convention”) applies, treaty benefits under Article X(6) of the Convention may be claimed by an LLC on behalf of its members with respect to an amount of profit attributable to a Canadian permanent establishment only if the amount is considered to be derived, pursuant to Article IV(6), by a US-resident company that is a “qualifying person” under Article XXIX-A(2), or by a US-resident company that is



entitled, with respect to that amount, to treaty benefits pursuant to Article XXIX-A(3). To the extent that the earnings of the LLC are considered to be derived by US-resident individuals under Article IV(6), Article X(6) does not apply, with the result that branch tax will be payable in respect of those earnings at a rate of 25% under Part XIV of the Act.

While it remains the CRA's position that a fiscally transparent LLC is not a resident of the United States for the purposes of applying the Convention, Article IV(6) establishes the parameters under which treaty benefits may be claimed by a fiscally transparent LLC in respect of income, profits or gains derived through the LLC by its US-resident members. By contrast, the United States Treasury Department Technical Explanation of the Fifth Protocol indicates that an S-corporation is ordinarily accepted to be a resident of the United States under the Convention. Thus, Canada allows treaty benefits to an S-corporation under Article X(6).

However, for taxation years of an LLC that began prior to the 2009 entry into force of Article IV(6), the CRA will accept a claim for treaty benefits under Article X(6) in light of the decision in *TD Securities* if:

- (a) the LLC can demonstrate that it was wholly-owned, throughout the relevant taxation year, by one or more persons who were residents of the United States for the purposes of the Convention, and
- (b) a notice of objection for the relevant taxation year is filed within the time prescribed by the Act, or where the CRA has confirmed an assessment to which the LLC had objected, the LLC appeals the assessment within the time prescribed by the Act, and the LLC is not precluded from raising the claim in the notice of appeal.

Slide 17 - Functional Currency  
Subsections 261(18) and (21)

#### Question

Can you provide examples of the types of situations in which the CRA would consider applying the anti-avoidance rules in subsection 261(18) and 261(21)? Please note that the language may allow the CRA to deny a functional currency election many years after it has been made.

#### Response

The November 10, 2008 Department of Finance Explanatory Notes state that subsection 261(18) of the Act deals with transfers of property from one corporation to a related corporation for the purpose of changing, or enabling the changing of, the currency

in which the Canadian tax results in respect of the property, or property substituted for it, for a taxation year would otherwise be determined.

Subsection 261(18) confers discretionary authority on the Minister of National Revenue to direct a corporation to report its the Canadian tax results for any one or more taxation years in a particular currency if:

- (i) there is a direct or indirect transfer of property by one corporation to another corporation;
- (ii) the transferor and the transferee of the property are related at the time of transfer, or become related in the course of a series of transactions or events that includes the transfer;
- (iii) the transfer time is in a functional currency year of the transferor (or would be in the absence of subsections 261(16) and (17)) and the transferor and the transferee have different tax reporting currencies at the time of the transfer, or the transfer time is in a reversionary year of the transferor (or would be in the absence of subsections 261(16) and (17)) and not in a reversionary year of the transferee; and
- (iv) it can reasonably be considered that one of the main purposes of the transfer, or any portion of a series of transactions or events including the transfer, is to change or to enable the changing of the currency in which the Canadian tax results in respect of the transferred property would otherwise be determined.

While the following examples should by no means be considered an exhaustive list, the CRA would generally consider issuing a direction to require a corporation to determine its Canadian tax results in a particular tax reporting currency in circumstances where transactions are undertaken with a view to circumventing the eligibility restrictions set out in subsection 261(3). In particular, where a corporation that is otherwise prohibited from determining its Canadian tax results in a particular tax reporting currency, directly or indirectly transfers property to another corporation to enable the determination of the Canadian tax results in respect of the transferred property in that other tax reporting currency, the CRA would consider a direction to require the other corporation to report its Canadian tax results in respect of the transferred property in the transferring corporation's original tax reporting currency.

For example, consider a corporation, Canco, that originally elected to report its Canadian tax results in US dollars commencing with its 2008 taxation year, but decided in 2010 to revoke that election and revert back to the Canadian dollar as its tax reporting currency for 2011 and subsequent taxation years. As a result of revoking the election, paragraph 261(3)(e) will prohibit Canco from making another functional currency election in the future.

In the absence of subsection 261(18), Canco may attempt to circumvent this prohibition by first incorporating Cansub, a wholly-owned subsidiary of Canco. In one case, Canco could transfer its property to Cansub, having Cansub elect to report its Canadian tax results in US dollars. Alternatively, Canco could amalgamate with Cansub to form Newco, a corporation that could otherwise be eligible to file a functional currency election. However, in either of these examples, the CRA would consider issuing a direction under paragraph 261(18)(e) that would require either Cansub or Newco, as applicable, to report its Canadian tax results in Canadian dollars.

As well, subsection 261(21) provides an additional anti-avoidance measure to protect against potential abuses of the functional currency tax reporting regime that may arise in transactions that are directly or indirectly entered into between related corporations with different tax reporting currencies. However, unlike subsection 261(18) which contains a purpose test for application, subsection 261(21) applies in respect of any transaction meeting the criteria in subsection 261(20), regardless of the purpose of the transaction in question. The example provided in the Department of Finance Explanatory Notes to subsections 261(20) and (21) illustrate how the provision can apply in the context of a loan repayment between a parent and a subsidiary.

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