# *2009 IFA Seminar Toronto, Ontario May 21-22, 2009*

## *Question 1 – Beneficial Ownership*

Given the FCA decision in *Prevost Car,* what is the CRA's current view in regard to beneficial ownership as it relates to back-to-back dividends, interest and royalties?

### *CRA Response*

The Federal Court of Appeal in *The Queen v. Prévost Car Inc.* confirmed the Tax Court's decision that the Dutch holding company, Prévost Holding B.V. ("Prévost B.V.) was the beneficial owner of dividends paid to it from Prévost Car Inc. and therefore, Prévost B.V. was entitled to the 5% withholding rate under Article 10 of the *Canada-Netherlands Income Tax Convention*.

In the decision, the Federal Court of Appeal confirmed the Tax Court's finding that the "beneficial owner" of a dividend is the person who receives the dividend for his or her own use and enjoyment and assumes the risk and control of the dividend. In interpreting the meaning of the term "beneficial owner" as it applies to Canada's income tax conventions, the Court referred to the OECD *Conduit Companies Report* [1], and the 2003 amendments to the OECD Commentary [2] , both of which support the position that the term "beneficial owner" requires something more than strict legal title. In this respect, the Court implied that where an intermediary acts as a mere conduit or funnel in respect of an item of income, the intermediary would not have sufficient economic entitlement to the income to be considered the "beneficial owner". The CRA will examine future back-to-back dividend, interest and royalty cases that it encounters with a view to whether an intermediary could, on the facts, be considered a mere conduit or funnel.

The CRA is in the process of preparing guidance for public distribution on its views of what constitutes abusive treaty shopping. To those cases that it considers abusive, the CRA intends to apply Limitation on Benefits provisions (in those treaties that contain such provisions), the GAAR, and specific anti-abuse provisions such as those in Articles 10, 11 and 12 of the *Canada-U.K. Income Tax Convention*, as well as the "beneficial owner" principle as now defined by the courts.

**CRA document number: 2009-032145**

ENDNOTES

1 Double Taxation Conventions and the Use of Conduit Companies, adopted by the OECD Council on November 27, 1986
2 Organization for Economic Co-operation and Development, Model Tax Convention on Income and on Capital

***Fifth Protocol***

***Question 2 – Articles IV(6) and XXI(4)***

Assume that shares of an LLC are held by a number of U.S resident persons and that no single shareholder is related to any other shareholder. Further, no single shareholder has a controlling interest in the LLC. The LLC owns all the shares of a Canadian resident corporation (Canco).

(1) Will interest and/or dividends paid by Canco to the LLC be exempt from withholding tax to the extent that any portion of the interest and/dividends are considered to be derived (by virtue of paragraph 6 of Article IV) by a shareholder that is a tax exempt entity described in paragraph 2 or 3 of Article XXI? In particular, is the determination of whether the tax exempt entity is "related" to Canco (for purposes of paragraph 4 of Article XXI) made at LLC level or at the shareholder level?

(2) Would your answer be the same if the LLC were a partnership?

***CRA Response***

(1) The definition of "related person" in section 251 of the Act will be used to determine if a shareholder of the LLC is related to Canco. The CRA will not attribute the relationship between the LLC and Canco to any of the shareholders of the LLC. Instead, where the conditions of paragraph 6 of Article IV of the Treaty are satisfied in respect of the amount derived by a shareholder through the LLC, the CRA will determine whether that shareholder is related to a subsidiary of the LLC on the same basis that we would determine if a shareholder of any other corporation were related to a subsidiary of that corporation.

(2) The CRA will apply the same approach with partnerships (*i.e*, the CRA will not attribute the relationship between the partnership and Canco to any of the members of the partnership).

**CRA document number: 2009-031941**

***Question 3 - Article IV(7)(b)***

A U.S. resident corporation (USCo) owns all the shares of a Canadian resident ULC which, in turn, owns all the shares of another Canadian corporation (Canco). The ULC is a disregarded entity under the taxation laws of the U.S. Canco pays a dividend to the ULC which pays a dividend of an equal amount to USCo. Would the dividend paid by the ULC to USCo be subject to Article IV(7)(*b*)?

### *CRA Response*

Article IV(7)(*b*) would apply – it is the CRA's position that the only relevant amount for the purposes of applying Article IV(7)(*b*) is the dividend paid by the ULC to USCo.

### *Question 4 - Articles IV(6) and (7)*

Under what circumstances would the CRA consider the treatment of an amount of income to be the "same" for the purposes of applying paragraphs 6 and 7 of Article IV of the Treaty?

### *CRA Response*

Under review

### *Question 5 - Article V(9)(b)*

Is there a discrepancy between the CRA's position that subparagraph 9(b) of Article V of the Treaty could apply where services are rendered between related parties and the US Joint Committee on Taxation's statement in their report entitled "Explanation of the proposed Protocol to the Income Tax Treaty Between the United States and Canada" (JCX-57-08) dated July 8, 2009? In their explanation, the Joint Committee summarized a statement in the TE as follows:

> "paragraph 9 only applies to services provided by the enterprise to third parties and not to services provided to that enterprise (*i.e*. inter-company services)."

### *CRA Response*

The CRA continues to be of the view that a related party may be a "third party" and therefore paragraph 9 of Article V can give rise to a permanent establishment where the services in question are rendered to a related party. The CRA agrees with the comment in the TE to the effect that paragraph 9 of Article V cannot give rise to a PE for an enterprise when services are rendered to that enterprise. It is not clear to the CRA that its views are contrary to the views of the U.S. Joint Committee.

**CRA document number: 2009-031944**

### *Question 6 - Article XXIX A(3)*

A safe harbour applies in certain U.S. income tax treaties for purposes of determining whether an active trade or business conducted in the residence country is "substantial" vis-à-vis the activities giving rise to income in the source state. In each of these treaties, as in the *Canada-U.S. Tax Treaty* ("the Treaty"), the determination of substantiality is based on all the facts and circumstances. However, in addition, in the foregoing U.S. treaties the trade or business will be deemed substantial if for the preceding year, or for the average of the three preceding years, the asset value, the gross income and the payroll

expense that are related to the trade or business in the residence state equals at least 7.5% of the asset value, the gross income and the payroll expense, respectively, that are related to the activity that generated the income in the source state, and the average of the three ratios exceeds 10%. In determining whether an active trade or business conducted in the United States is "substantial" vis-à-vis the activities giving rise to income in Canada, would the CRA consider it relevant that the safe harbour described above (although not part of the Treaty) was met by the U.S. active trade or business? If not, can the CRA provide additional guidance on how it will interpret and apply the "substantiality" requirement?

### *CRA Response*

Paragraph 3 of Article XXIX A of the Treaty provides as follows:

> Where a person is a resident of a Contracting State and is not a qualifying person, and that person, or a person related thereto, is engaged in the active conduct of a trade or business in that State (other than the business of making or managing investments, unless those activities are carried on with customers in the ordinary course of business by a bank, an insurance company, a registered securities dealer or a deposit-taking financial institution), the benefits of this Convention shall apply to that resident person with respect to income derived from the other Contracting State in connection with or incidental to that trade or business (including any such income derived directly or indirectly by that resident person through one or more other persons that are residents of that other State), but only if that trade or business is substantial in relation to the activity carried on in that other State giving rise to the income in respect of which benefits provided under this Convention by that other State are claimed.

The Technical Explanation ("TE") to the Fifth Protocol provides as follows (emphasis added):

> As described above, income that is derived in connection with, or is incidental to, an active trade or business in a Contracting State, must pass the substantiality requirement to qualify for benefits under the Convention. The trade or business must be substantial in relation to the activity in the other Contracting State that gave rise to the income in respect of which benefits under the Convention are being claimed. To be considered substantial, it is not necessary that the trade or business be as large as the income-generating activity. The trade or business cannot, however, in terms of income, assets, or other similar measures, represent only a very small percentage of the size of the activity in the other State.
>
> The substantiality requirement is intended to prevent treaty shopping. For example, a third-country resident may want to acquire a U.S. company that manufactures television sets for worldwide markets; however, since its country of residence has no tax treaty with the United States, any dividends generated by the investment would be subject to a U.S. withholding tax of 30 percent. Absent a substantiality test, the investor could establish a Canadian corporation that would operate a small outlet in Canada to sell a few of the television sets manufactured by the U.S. company and earn a very small amount of income. That Canadian corporation could then acquire the U.S. manufacturer with capital provided by the third-country resident and produce a very large number of sets for sale in several countries, generating a much larger amount of income. It might attempt to argue that the U.S.-source income is generated from business activities in the United States related to the television sales activity of

> the Canadian parent and that the dividend income should be subject to U.S. tax at the 5 percent rate provided by Article X (Dividends) of the Convention. However, the substantiality test would not be met in this example, so the dividends would remain subject to withholding in the United States at a rate of 30 percent.

Neither the text of paragraph 3 of Article XXIX A nor the TE refer to a safe harbour in the interpretation and application of the term "substantial". The CRA does not consider it relevant that other tax treaties concluded by the United States may contain other means of testing the "substantial" requirement, since that approach does not appear in the Treaty.

CRA's view is that the guidance underlined above in the TE provides a basis for applying the "substantial" requirement. Taking this guidance into consideration, the CRA is of the view that, in applying the substantial requirement test:

- The size of the trade or business in the U.S. need not be "as large as" the income-generating activity in Canada; but it must be more than "a very small percentage" of the size of that activity.

- The phrase, "a very small percentage" imports a *de minimis* standard, one that is to be applied in the context of all the facts and circumstances of each particular case, with a view to preventing treaty shopping.

- In comparing the size of the trade or business in the U.S. and the size of the income-generating activity in Canada, the CRA will consider factors such as income, assets, payroll expense, the size and nature of relevant markets or other similar measures.

**CRA document number: 2009-034588**

***Question 7 - Article XXIX A(3)***

The active trade or business exception in paragraph 3 of Article XXIX A is available to a U.S. resident that is not a qualifying person but is engaged in the active conduct of a trade or business in the U.S. (other than the business of making or managing investments, unless those activities are carried on with customers in the ordinary course of business by a bank, an insurance company, a registered securities dealer of a deposit-taking financial institution). Unlike the Canada-U.S. Tax Convention, the U.S. Model Convention excludes a business of making or managing investments "for the resident's own account". Although these words are not used in Article XXIX A, it would seem inconsistent with the objective of the LOB Article (prevention of treaty shopping) that a business of managing the investments of arm's length investors could not qualify for the active trade or business exception.

Does CRA agree that the "business of making or managing investments" should be interpreted so that it is restricted to a business of making or managing investments, where the investments are those of the U.S. resident or a related party?

### *CRA Response*

No - the absence of the qualifying phrase, “for the resident’s own account” appears to be result of a deliberate choice by the treaty negotiators.

### *Question 8 - Article XXIX A(3)*

(1) Can the CRA confirm that income derived “in connection with” a U.S. trade or business includes income derived from a “complementary business” as described in the U.S. Model Technical Explanation?

(2) What is the CRA’s position on whether the gain on the sale of shares of a Canadian subsidiary of a U.S. resident corporation can qualify for the active trade or business exception in circumstances where a portion of the value of the shares of the Canadian subsidiary is attributable to a connected business and another portion is attributable to a business that is not connected with the relevant active trade or business in the U.S.?

(3) What is the CRA’s position with respect to capital gains on the disposition of shares of Canco that derive their value from businesses carried on by Canco’s foreign affiliates?

### *CRA Response*

(1) Paragraph 3 of Article XXIX A extends the benefits of the Treaty to a resident of a Contracting State (other than a qualifying person) with respect to an item of income derived from the other State in connection with, or incidental to, the active conduct of a trade or business (other than certain investment businesses) in the State of residence if trade or business is substantial in relation to the activity carried on in the other State. This paragraph applies to income derived by a resident of a Contracting State directly or indirectly through one or more persons who are resident in the other Contracting State.

In determining whether Canadian-source income has been derived by a U.S. resident in connection with an active trade or business in the U.S., the CRA will be guided by the commentary set out in the Technical Explanation to the Fifth Protocol and the 2006 U.S. Model Technical Explanation to Article 22 of the 2006 U.S. Model Income Tax Convention. In general terms, we would consider Canadian-source income to be derived “in connection with” a trade or business in the U.S. if the income is derived from an activity in Canada that is a part of, or is complementary to, the trade or business in the U.S.

An activity in Canada will be considered to be *part of* a trade or business in the U.S. if the trade or business in the U.S. is upstream, downstream or parallel to the activity in Canada. Business activities will generally be considered to be upstream, downstream or parallel to each other if they relate to the production of the same types of products or the provision of the same or similar services. Business activities will generally be considered to be *complementary* if they are part of the same industry and the activities are

interdependent (*i.e*., success or failure of one activity will tend to result in success or failure of the other).

(2) In circumstances where a U.S. resident realizes a gain from the disposition of the shares of a Canadian subsidiary, and the value of the shares of the subsidiary is attributable partly to a connected business and partly to a business that is not connected to the relevant U.S. trade or business, we would consider only the portion of the gain that relates to the connected business to be income described in paragraph XXIX A(3). For example, if 75% of the value of the shares was attributable to assets used in the connected business, we would consider 75% of the taxable capital gain to be income described in paragraph XXIX A(3).

(3) Under review

**CRA document number: 2009-033640**

### ***Question 9 - Fifth Protocol Guidance***

What is the status of pending written guidance regarding the interpretation of the Fifth Protocol to the Canada-U.S. Income Tax Convention (the "Fifth Protocol") including guidance in regard to reliance on the Canada – U.S. Income Tax Convention (the "Treaty")?

#### ***CRA Response***

The CRA has prepared and provided to publishers various Technical Interpretations regarding the interpretation of various provisions of the Fifth Protocol. As well, the CRA will be issuing three *Income Tax Technical News* ("ITTN") in the near future. The first will address questions asked at the 2008 CTF, the second ITTN will deal with the Taxation of Roth IRAs and the Impact of Article XVIII of the Treaty which was amended by the Fifth Protocol and the third ITTN will deal with the impact of the Fifth Protocol on the taxation of cross-border stock options where employment is exercised in more than one country.

The CRA will also be issuing Guidelines for Taxpayers Requesting Treaty Benefits pursuant to paragraph 6 of Article XXIX A of the Treaty. We expect that this information will be available on the CRA's internet site by the end of the month. There is a new email address at which taxpayers may contact Competent Authority regarding the discretionary relief provision of the LOB Article: *CA-LOB@cra.gc.ca or AC-RAA@arc.gc.ca*.

In the context of Part XIII tax, the CRA is developing guidance for Canadian resident payers and non-residents regarding the availability of Treaty benefits and regarding the administrative procedures which must be followed by an LLC and other fiscally transparent entities for claiming entitlement to Treaty benefits for their members.

It is expected that Information Circular 76-12R6 and other CRA publications will be updated to include the new information and procedures.

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## *Question 10 - Part XII and Convertible Debt*

At the CRA Round Table at the 2008 Canadian Tax Foundation Annual Conference, the CRA responded to certain questions concerning the tax treatment under Part XIII of the ITA of convertible debt obligations held by non-residents. Following the CRA Round Table, leave to appeal to the Supreme Court of Canada was denied in the case of *Provigo Inc., Tembec Inc., and Cascades Inc*., 2008 DTC 6601 (FCA).

Now that leave to appeal to the Supreme Court of Canada has been denied in the case of *Provigo Inc., Tembec Inc., and Cascades Inc*., the CRA appears to be in a position to update its responses given at the CRA Round Table. More specifically, can the CRA provide comments on the following:

1. Can the CRA specify whether the decision of the Federal Court of Appeal in the case of *Provigo Inc., Tembec Inc., and Cascades Inc*. has influenced its views concerning the application of subsection 214(7) and paragraph 214(8)(c) of the ITA with respect to convertible debentures issued by a Canadian corporation to a non-resident holder?

2. If the CRA considers that a convertible debenture does not qualify as an “excluded obligation” within the meaning of subsection 214(8) of the ITA, what is the CRA’s position concerning the application of subsection 214(7) of the ITA to the conversion of a convertible debenture for shares of the issuer when the FMV of the shares issued on the conversion exceeds the principal of the convertible debenture?

   More specifically, what is the “price for which the obligation was assigned or otherwise transferred at that time” under paragraph 214(7)(d) of the ITA in that situation? Moreover, does the CRA agree that the “price for which the obligation was issued” under paragraph 214(7)(e) of the ITA in that situation is the issue price of the convertible debenture (i.e. face value less any discount)?

   Based on its comments with respect to question 10-3 at the CRA Round Table, the CRA position seems to be that for the purposes of paragraph 214(7)(d), the price of a convertible debenture at the time of its conversion is normally the stated principal amount of the debenture (being the amount added to the stated capital of the shares issued by the debtor corporation on the conversion).

3. Does the “principal amount” of a convertible debenture for the purposes of the application of paragraph 214(8)(c) of the ITA correspond to the stated principal of the convertible debenture or a greater amount equal to the FMV of the shares received on the conversion of the debenture?

4. How should the yield of a convertible debenture be calculated for the purposes of the application of paragraph 214(8)(c) of the ITA?

5. If the CRA takes the position that the "price for which the obligation was assigned or otherwise transferred at that time" under paragraph 214(7)(d) of the ITA is equal to the FMV of the shares received on the conversion by the holder of the convertible debenture, would the CRA consider that the amount deemed to be a payment of interest under subsection 214(7) of the ITA constitutes "participating debt interest" within the meaning of the definition in subsection 212(3)?

6. If subsection 214(7) of the ITA applies to a convertible debenture and the amount deemed to be a payment of interest under subsection 214(7) represents "participating debt interest" within the meaning of the definition in subsection 212(3), would this characterization taint the status of the fixed interest previously paid pursuant to the terms of the convertible debenture (assuming it was not already "participating debt interest"), on the basis that the definition of "participating debt interest" arguably applies to all interest on an obligation when "all or any portion of which interest is…computed by reference to revenue, profit, cash flow,…"?

7. Would the positions of the CRA stated in response to the questions above change if the debt of the issuer is an exchangeable debenture?

### *CRA Response*

There are many varieties of convertible securities in the market. Moreover, the fundamental characteristics of convertible debentures can differ significantly from one situation to another. Accordingly, it is not possible for the CRA to provide general comments or general positions concerning the application of subsection 214(7) and paragraph 214(8)(c) of the ITA with respect to convertible debentures that will apply to all possible situations.

However, we are prepared to provide the following comments concerning traditional convertible debentures. Debentures that we consider to be traditional convertible debentures have in general at least the following terms and conditions:

(a) The debentures are unsecured subordinated debts.
(b) The issuer is a public corporation.
(c) The debentures are issued for a fixed amount of money in Canadian dollars (for instance $1,000) that represents the face value of the debentures. The debentures are issued with no original discount.
(d) The debentures bear interest at a commercial fixed rate per year calculated on their face value. The interest on the debentures is paid by the issuer at least annually.
(e) The debentures are convertible at any time at the holders' option into the common shares of the issuer prior to maturity. Some debentures have an initial non-conversion period.

(f) The terms of the debentures specifically provide either a fixed conversion price (specifying the fixed price paid per common share to acquire the common shares through the conversion of each debenture) or a fixed conversion ratio (specifying the number of common shares that can be obtained for each debenture). The conversion ratio may be determined by dividing the conversion price into the face value of the debenture. In some cases, the security contract may provide for certain changes in the conversion price or conversion ratio over time.
(g) The conversion price exceeds the price at which at which the common shares of the issuer could have been purchased on the market at the time the debentures are issued (for example, with a 25% conversion premium).
(h) The debentures have a specified maturity date.
(i) At maturity, the debentures are redeemable by the issuer at a redemption price of 100% of the face value, plus accrued and unpaid interest.

Subject to certain exceptions, subsection 214(7) of the ITA provides that when a debenture or other debt obligation described in paragraph 214(7)(a) issued by a person resident of Canada is assigned or otherwise transferred by a non-resident person to a person resident in Canada, the amount (the "Excess"), if any, by which the price for which the obligation was assigned or transferred exceeds the price for which the obligation was issued, is deemed (for the purposes of Part XIII of the ITA) to be a payment of interest on that obligation made by the person resident in Canada to the non-resident. Under subsection 214(14) of the ITA, the redemption or cancellation of an obligation held by a non-resident person is deemed to be an assignment of the obligation by the non-resident person for the purposes of section 214 of the ITA. It follows that on the conversion of a convertible debenture into shares of the issuer, there could be a deemed payment of interest.

Where there is a conversion of a traditional convertible debenture by its original holder for common shares of the issuer, it is our view that in general there would be no Excess under subsection 214(7) of the ITA. Accordingly, no amount is deemed to be a payment of interest by the issuer (person resident in Canada) to the non-resident person for the purposes of Part XIII. For the purpose of paragraph 214(7)(d) of the ITA, the price for which the traditional convertible debenture is assigned on the conversion, is the amount determined by multiplying the fixed conversion price by the number of shares received on the conversion, that is, an amount corresponding to the face value of the traditional convertible debenture. This is the price that is determined under the terms and conditions of a traditional convertible debenture. For the purpose of paragraph 214(7)(e) of the ITA, the price for which the traditional convertible debenture is issued is its face value (principal) and issue price.

The comments above are consistent with our general comments in response to question 10-3 at the CRA Round Table at the 2008 CTF Annual Conference, and are not directly influenced by the comments of the Federal Court of Appeal in the case of *Provigo Inc., Tembec Inc., and Cascades Inc*. The issue in this case involved the application of paragraph 20(1)(f) of the ITA to convertible debts.

Based on our conclusion concerning the non-application of subsection 214(7) of the ITA, it appears that there is no need at this time to comment on your questions concerning subsection 214(8) of the ITA and the definition of “participating debt interest” in subsection 212(3) of the ITA.

We are not prepared at this time to comment on your question with respect to exchangeable debentures without knowing all the relevant facts in relation to a particular situation (including the terms of the exchangeable debentures) and because of time constraints. If you have concerns concerning the application of Part XIII of the ITA with respect to exchangeable debentures in the context of proposed transactions, we encourage you to request an advance income tax ruling.

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