

International Fiscal Association of Canada



2008 International Tax Seminar

The 5th Protocol to the Canada - US Tax Convention Limitation on Benefits and Withholding Taxes

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Presentation Objective and Take-Away

- Overview of LOB provisions within 1984 Convention as modified by the 5th protocol
 - Historical perspective
 - US LOB policy objectives & core provisions
 - Central provisions of 5th protocol
 - Withholding tax highlights with focus on LOB effective dates
- Concern for the 3rd country investor
 - Possible loss of treaty benefits
 - Possible retroactive application



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Limitation on Benefits – Historical Perspective

Convention came into force in 1984 and modified by protocol four times
– The 1942 Convention was terminated at Article XXX(6)

The 3rd protocol was in 1995 which introduced Article XXIXA
– Limitation of Benefits (“LOB”)

Existing LOB not reciprocal

– Canada to police treaty shopping with general anti-avoidance rule (“GAAR”)

5th Protocol makes LOB reciprocal

– Canada has taken substantial policy shift

– Canada’s first bilateral LOB

- Learning curve for Canada Revenue Agency and taxpayers
- Look to US LOB policy objectives for guidance
- Agreed Technical Explanation targeted



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US LOB Policy Objectives and Core Provisions

US Tax Treaty Policy

- Promotion of foreign inbound investment by reducing or eliminating source-country taxation
- Tax treaties are intended to provide benefits to US residents and residents of treaty partners on a reciprocal basis
- Treaty benefits not intended to flow to third-country residents, i.e., safeguarded from abuse (treaty shopping)
- Effective anti-treaty shopping rule should separate legitimate business structures from those established to obtain treaty benefits.
- Note:
 - The LOB is intended to be an objective test of sufficient nexus
 - Legislative action to overturn treaty shopping



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US LOB Policy Objectives and Core Provisions

Core LOB provisions [2006 US Model Treaty]

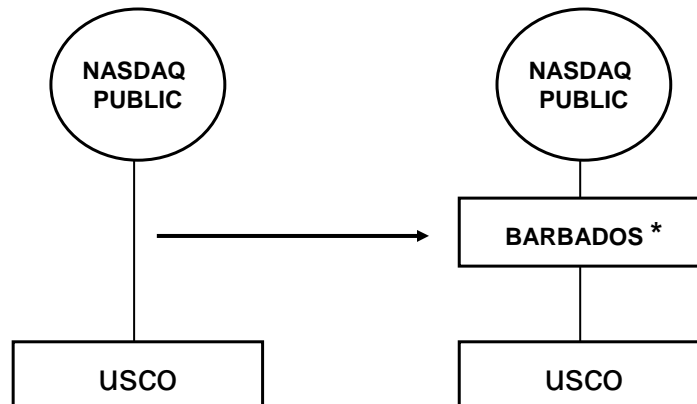
- LOB provisions are the result of an evolutionary process
 - Qualified Person:
 - Public company test
 - Ownership and base erosion test
 - Non-Qualified Person: Active trade or business test
- Note:
 - Derivative benefits test absent from 2006 Model but central to the US – Canada LOB
 - 2006 Model treaty modifications to publicly traded company test absent from US – Canada Convention



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US LOB Policy Objectives and Core Provisions

Qualified Person – Public Company Modification



* Primarily and Regularly Traded in Barbados, or Local Management & Control in Barbados, per US 2006 Model Treaty (not part of protocol) 6



Overview of US – Canada LOB under 5th Protocol

Qualifying Person - Entitled to all benefits of the Convention

- Defined in Article XXIXA(2) to include:
 - Natural persons and government entities
 - Publicly traded entity test (direct or indirect)
 - Private ownership/base erosion test

Non-qualifying person – Entitled to limited benefits

- Satisfies one of two tests under Articles XXIXA(3) & XXIXA(4)
 - Active trade or business test
 - Derivative benefits test



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Overview of US – Canada LOB under 5th Protocol

Active trade or business test:

Benefits of the Convention applicable to resident of contracting state engaged in active conduct of trade or business in that state

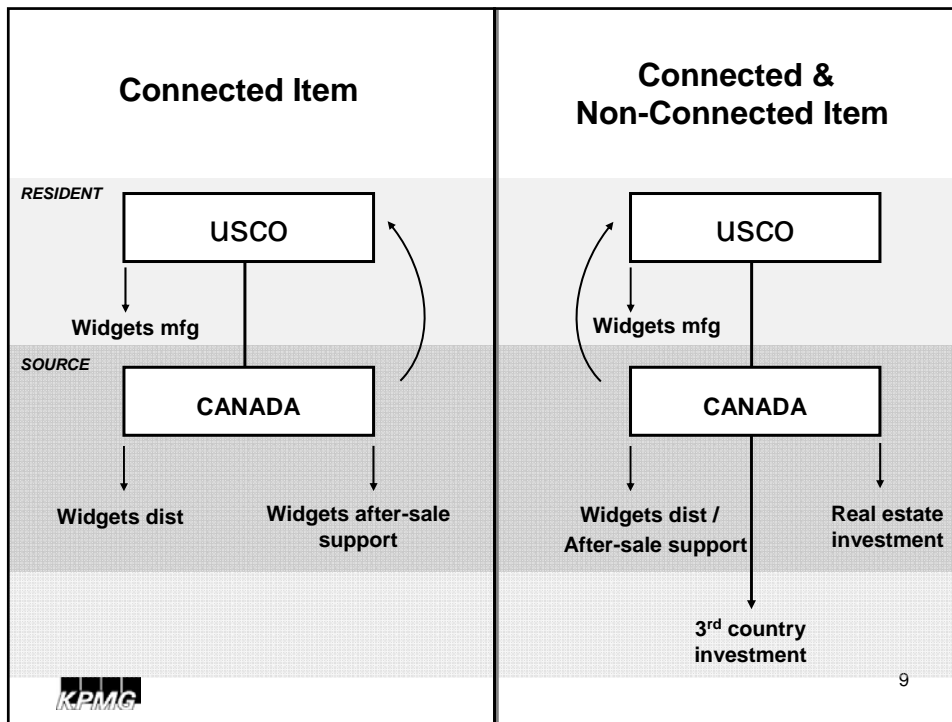
- limited to item of income *connected or incidental* to such trade or business
- Activity *substantial* in relationship to other contracting state

Note: Active trade or business not defined – see local law [section 367(a) of IRC]

- For profit activity conducted through employees
- Excludes investment activities and financing activities
- Connected or incidental: US rules look to source state activity
 - Upstream, downstream, parallel
 - Problem: mixed business activities and investment
- Substantial: Resident activity not diminutive compared to source state activity



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Overview of US – Canada LOB under 5th Protocol

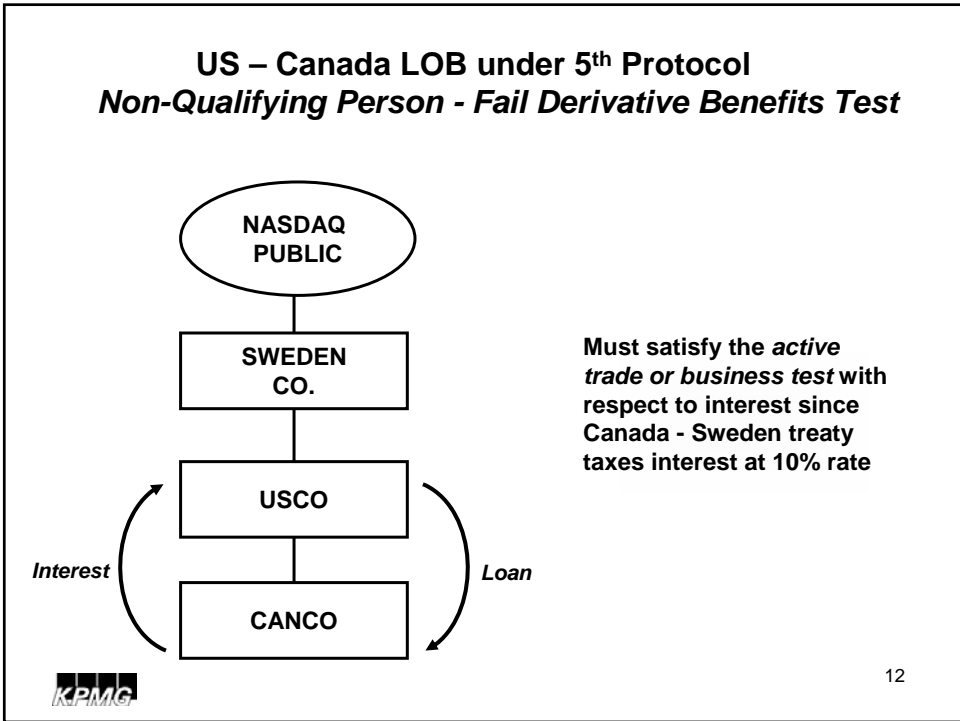
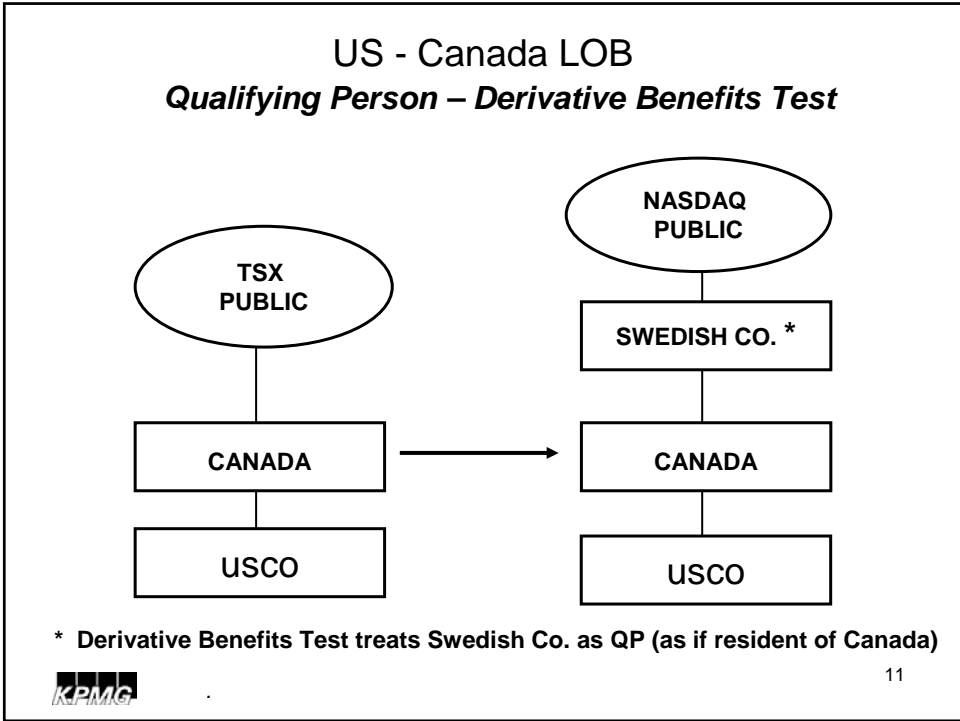
Derivative benefits test:

Benefits of the Convention apply only to dividends, interest, and royalties where resident satisfies both an ownership test and a base erosion test

- Resident of treaty country and entitled to benefits under treaty
- Satisfy QP test *as if* resident in contracting state
- Same or lower treaty benefits

Publicly traded entity test: A company or trust whose *principal class of shares* or units (and any *disproportionate class of shares* or units) is *primarily and regularly* traded on one or more *recognized stock exchanges*

- Recognized stock exchange
 - Registered with the SEC as a national securities exchange for purposes of the Securities Exchange Act of 1934
 - » IRC Section 884 branch level tax provisions exclude the OTC exchanges (Pink Sheets)
 - Prescribed or designated Canadian stock exchange under ITA



US – Canada LOB under 5th Protocol

Other considerations

- Competent authority override – Article XXIXA(6)
 - Taking all factors into consideration, is person obtaining benefits not otherwise available
 - Not appropriate to deny benefits of Convention to such person

- General anti-abuse provision – Article XXIXA(7)
 - A Contracting State can deny benefits where application results in abuse of the provisions of Convention



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US – Canada LOB under 5th Protocol

Canadian issues with respect to policy change

- Will Canada follow US LOB policy objectives

- Definitions may be problematic, e.g., active conduct of trade or business

- Pending GAAR treaty shopping cases



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US – Canada Withholding Tax under 5th Protocol Elimination of Withholding Tax on Interest

Article XI of 1984 Convention amended to exempt interest from source-country taxation

- Applies to both arm's length and non-arm's length indebtedness as defined under source country law
 - Exceptions: borne by PE; excess interest; contingent interest
- Effective Date Provisions not clear:
 - Either January 1, 2008 (assuming 2008 *entry into force*), or 1st day of 2nd month beginning after *entry into force*
 - Per protocol Article 27(3)(d)(1)(a), related-party interest paid during [*read entire*] 1st calendar year that ends after *entry into force* can not exceed 7%
 - Per protocol Article 27(3)(d)(1)(b), related-party interest paid during 2nd calendar year that ends after entry into force can not exceed 4%



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Entry into Force of Entire Protocol Per Article 27 of 5th protocol

- The protocol shall *enter into force* following notification of completion of ratification process
- The provisions of the protocol will *have effect*:
 - In respect to taxes withheld at source, 1st day of 2nd month beginning after *entry into force*
 - In respect to other taxes, 1st day of taxable year beginning after year of *entry into force*
 - Thus, LOB Article 25 of 5th protocol enters into force on differing dates



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Deferral of Entry into Force of Entire 5th Protocol

The 1984 Convention ended the 1942 Convention per Article 30 paragraph 6

Article 30 at paragraph 5 provided*where the 1942 Convention was more beneficial than the 1984 Convention, the effective date of all provisions could be deferred to 1st day of taxable year beginning after year of entry into force*

The 5th protocol does not have such deferral provision

- Rely upon CA consideration to defer application LOB?

