

U.S.-Canada Protocol First Panel

International Fiscal Association
Canadian Branch Seminar
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Hybrid Entities: IV(6)

- 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:
 - 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
 - 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.

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Interpretation of IV(6)

U.S. Model Equivalent

- U.S. Model Treaty contains a simpler provision with the same general intent as Art. IV(6), in Art 1, para 6.
- “An item of income profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.”

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Interpretation of IV(6)

U.S. Model Equivalent

- Differences between U.S. Model and IV(6):
 - IV(6) does not apply where the fiscally transparent entity is resident in the source state.
 - Concern that NSULC income would be treaty entitled? Art. XXIX(2) prevents this, and U.S. Model Commentary asserts Canada’s right to tax in this case.
 - IV(6) requires that entity be fiscally transparent under the laws of the residence State , not “either Contracting State”. Not a material change in the context of LLCs. U.S. rule effectively requires transparency under residence State’s laws in any case.
 - IV(6) refers to “the person”, suggesting the income is attributed to the member of the fiscally transparent entity; Model Treaty language can be considered more ambiguous.
 - “Same treatment” requirement in IV(6) is not found in U.S. Model.

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Interpretation of IV(6) & (7)

- Interpretive issues are raised in Article IV(6) that carry through to Article IV(7)
- “Fiscally transparent”
 - Sources for Definition
 - Treaty
 - ITA
 - OECD
 - Technical Explanation?
 - Scope of Application
 - LLC
 - S Corporation
 - Partnership
 - Trusts

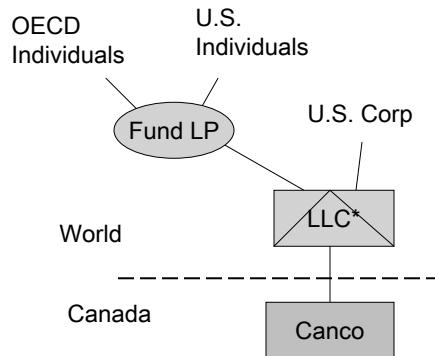
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Interpretation of IV(6) & (7)

- “Same Treatment”
- “Through an Entity”
- Permanent Establishment Issues
- Carrying on Business in Canada
- Tax Filing Obligations
- Interaction with other Source State Income/Loss
- Third Country Entities
- Tiers of Entities

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IV(6) Hybrid Entities: LLCs

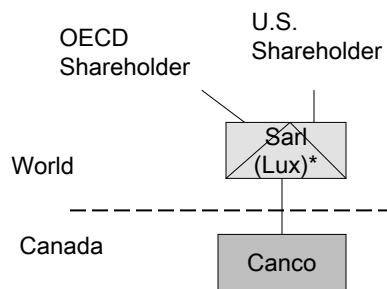


- Does Article IV(6) apply to look through the Fund LP?
- Are the dividends paid to the LLC subject to a 5% or 15% withholding tax?
- Article X(2), which looks through LLCs, applies only to corporate owners of the LLC
- Application of proposed subsection 116(5.01) to LLCs?

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IV(6) Hybrid Entities: Third Countries



- Sarl will claim benefits of Luxembourg Treaty
- OECD shareholder has no "look through" right to apply its treaty rates
- U.S. shareholder entitled to claim IV(6) benefits
 - Lower rate on interest withholding in non arm's length relationship
 - Art. XXI benefits for qualifying tax-exempt U.S. shareholder

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IV(6): Differences between Transparent Entities

- IV(6) does not level the playing field between transparent entities
- Partnerships presumably will continue to be disregarded for Treaty purposes for all members.
- LLCs will only allow Treaty benefits for U.S. resident members.
- Partnership tax reporting will continue to be at the partner level.
- LLC tax reporting may be at the entity level, with Treaty benefits taken into account.
- LLC interests will not be “shares in the capital stock of a company that is a resident of Canada” for Art XIII(3)(b)(i); partnership interests have no similar safe haven.
- LLCs presumably will be corporations for other, non-treaty purposes, such as thin capitalization, 25% ownership test for taxable Canadian property.
- Is there any difference in applying related person test for interest withholding transition rules between an LLC and a partnership?

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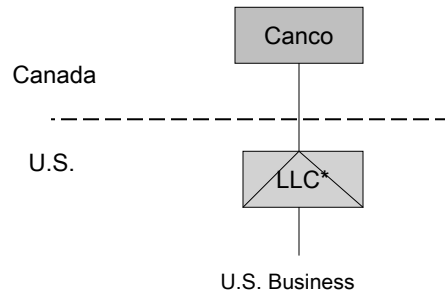
Hybrid Entities: IV(7)(a)

- 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:
 - 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.
 - Effective Date: Third Calendar Year ending after Entry into Force (2010?).

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IV(7)(a) Hybrid Entities

Canco above LLC



- Canadian Corp. is not entitled to treaty relief on U.S. business income earned through LLC.

- Subject to 30% branch tax.

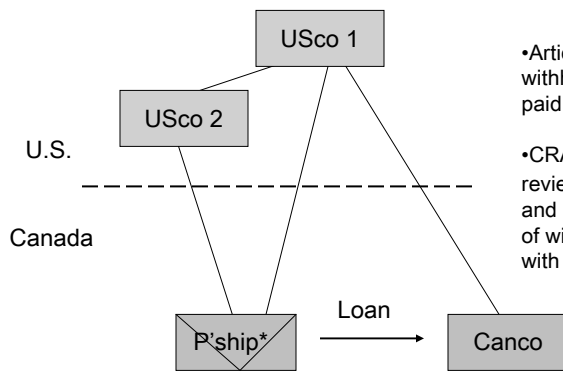
- LLC treated as a foreign affiliate for Canadian tax purposes.

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IV(7)(a) Hybrid Rules

Reverse Hybrid Partnership



- Article IV(7)(a) denies treaty withholding rates on interest paid to the partnership

- CRA had stated that it was reviewing these structures in 2005 and considered that the treaty rate of withholding was inconsistent with OECD Commentary

*Corporation for U.S. tax purposes

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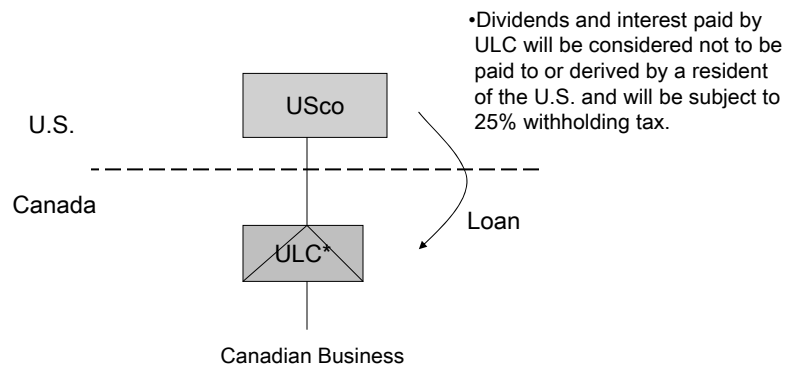
Hybrid Entities: IV(7)(b)

- 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:
 - The 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.
 - Effective Date: Third Calendar Year ending after Entry into Force (likely 2010)

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IV(7)(b) Reverse Hybrids

U.S. C Corp. above ULC

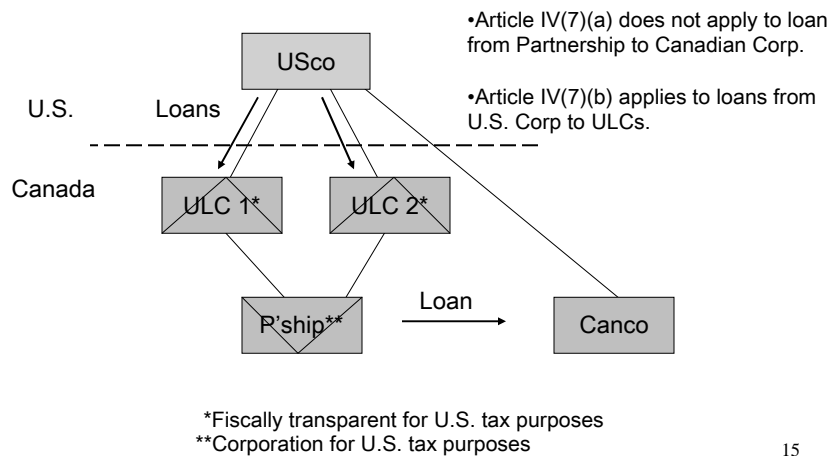


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IV(7)(b) Hybrid Rules

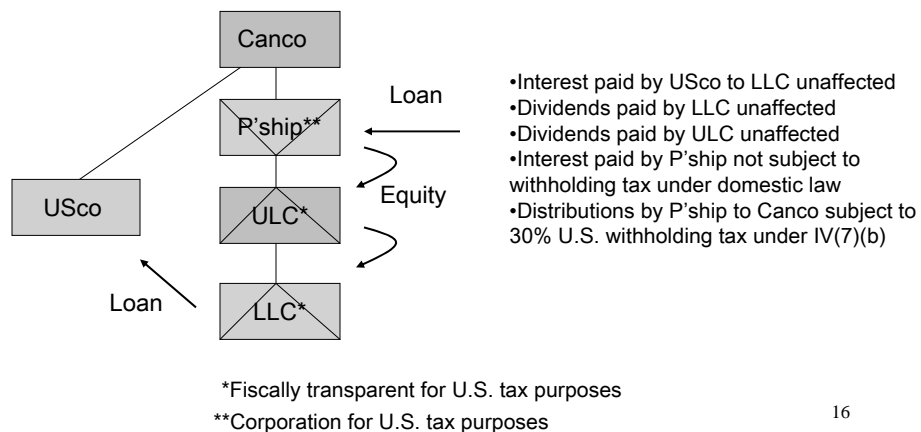
Reverse Hybrid Partnership



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IV(7)(b) Reverse Hybrids

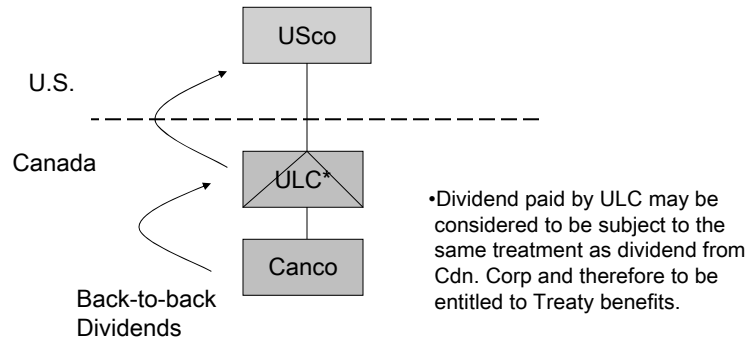
Tower Structure



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IV(7)(b) Reverse Hybrids

An Exception?

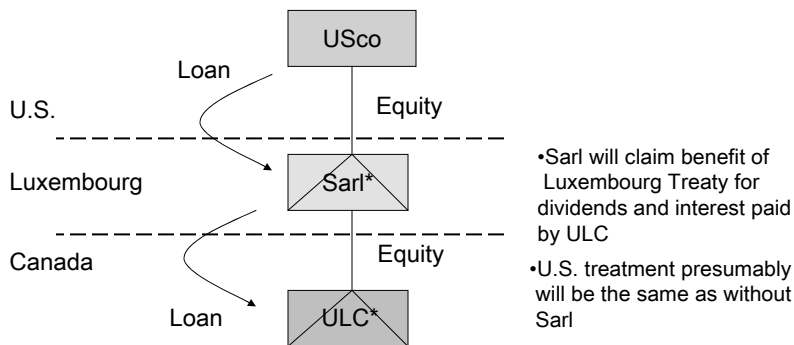


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IV(7)(b) Reverse Hybrids

An Alternative?



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Business Profits Art. VII

- Exchange of notes (Annex B – Par. 9) states that "the business profits to be attributed to a permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment" and that "the principles of the OECD Transfer Pricing Guidelines shall apply for purposes of determining the profits attributable to a permanent establishment."
- Clear that a P/E is treated as a separate enterprise for purposes of computing profit.
- What is the relevance of the decision of the Federal Court of Appeal in *Cudd Pressure Control Inc.* to the deduction of notional expenses by a P/E?
- Canada has not entered an observation to the 1994 OECD commentaries relating to Art. 7, which contemplate dealings between a P/E and its owner for purposes of computing profit.
- Art. VII(3) and s. 4(b) of the ITCIA apply to actual expenses, not notional expenses.

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“Exempt Surplus Guarantee”

- Article XXIV(2)(b) currently provides that Canada will allow a deduction to a Canadian corporation for dividends received from a U.S. resident foreign affiliate.
- Revised Article XXIV(2)(b) will instead provide that a Canadian corporation owning at least 10 per cent of the voting stock of a company resident in the U.S. from which it receives dividends in a taxable year is entitled to a credit against Canadian tax for “the appropriate amount of income tax paid or accrued” to the U.S. by the second company with respect to the profits out of which the dividends are paid.
 - Doesn’t address LLCs
 - Doesn’t specifically address consolidated groups
 - Which profits fund the dividend?
- Follows a general trend of replacing “exempt surplus guarantees” with tax credit guarantees for Treaties signed starting in 2001.
- Will be c. 10th Treaty to adopt this approach.

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