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The U.S. – Canada Tax Treaty Protocol: Impacts and Planning Opportunities

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The Canada – US Tax Treaty Protocol: Impacts and Planning Opportunities

OVERVIEW

- I. Common Cross-Border Planning Issues for Individuals and Companies
- II. Fifth Protocol – Important Dates and Interpretive Tools
- III. Limitation on Benefits / Residency
- IV. Select Cross-Border Investment Issues
- V. Cross-Border Services / Stock Option Benefits

The Canada – US Tax Treaty Protocol: Impacts and Planning Opportunities

I. Common Cross-Border Planning Issues for Individuals and Companies



I. Canada Inbound *from* US – Planning for Individuals

In General

1. Income Tax

- Tax residency
- Source of income
- Tax returns
- Retirement accounts



I. Canada Inbound *from* US – Planning for Individuals

In General

2. Social Security Tax

- Totalization agreements
- “Certificates of coverage”
- Compare US and foreign rates



I. Canada Inbound *from* US – Planning for Individuals

U.S. Perspective

1. Permanent Relocation (Section 877)
 - Expatriation to avoid tax as a US resident
 - Can be subject to an alternative tax



I. Canada Inbound *from* US – Planning for Individuals

U.S. Perspective

2. Temporary Relocation (Section 911)
 - Possible exclusion of certain foreign income from US tax
 - Foreign tax credits



I. Canada Inbound *from* US – Planning for Individuals

U.S. Perspective

- Tax returns
- “FBAR”s

I. Canada Inbound *from US* – Planning for Companies

In General

- Tax residency
- Choice of entity
- Blocker / deferral vs. pass-through structure
- Trade or business / permanent establishment
- Foreign source income / withholding tax
- Base erosion / thin capitalization
- Transfer pricing
- Tax returns



I. Canada Inbound *from US* – Planning for Companies

U.S. Perspective

- Check-the-box regulations
- “Subpart F” income
- Foreign currency / branch loss remittances
- Foreign tax credits
- “Toll charges” for outbound property transfers
- Repatriation / exit strategy
- FBARs / information returns
- Inversions



I. Canada Outbound *to* US – Planning for Individuals



In General

1. Income Tax

- Tax residency / tax on worldwide income
- Possible “departure” tax
- Tax credits for US tax
- Tax returns
- Tax-deferred / Retirement accounts

I. Canada Outbound *to* US – Planning for Individuals

In General

2. Social Security Tax

- Totalization agreements
- “Certificates of coverage”
- Compare US and foreign rates



I. Canada Outbound *to* US – Planning for Individuals



U.S. Perspective

1. Income Tax

Residency

- Green card/substantial presence/day count rules
- US resident election
- Tax on worldwide income/benefits of residency status
- Treatment of spouse
- Tax returns / FBARs / “sailing permit” upon departure

I. Canada Outbound *to* US – Planning for Individuals

U.S. Perspective

1. Income Tax

Non-Residency

- Tax on US source income only
- Limited deductions
- “FIRPTA” / real estate



I. Canada Outbound *to* US – Planning for Individuals

U.S. Perspective

2. Social Security Tax



I. Canada Outbound *to* US

– Planning for Companies

In General

- Tax residency
- Choice of entity
- Blocker/deferral vs. pass-through structure
- Foreign source income / withholding tax
- FAPI
- Foreign Tax credits for US taxes
- Trapped losses
- Repatriation/exit strategy
- Transfer pricing
- Use of LLCs



I. Canada Outbound *to* US

– Planning for Companies

U.S. Perspective

- Blocker vs. pass-through structure
- “Treaty shopping” / intermediaries
- Check-the-box regulations
- Trade or business/permanent establishment
- Two levels of tax (in corporate or in branch form)
- Withholding tax considerations / FATCA / IRS Form W-8BEN-E
- “Sandwich” structures
- Base erosion / thin capitalization
- FIRPTA
- Tax returns / reporting

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II. Fifth Protocol – Important Dates and Interpretive Tools



II. Fifth Protocol – Important Dates and Interpretive Tools

- The Fifth Protocol (the “**Protocol**”) was signed on September 21, 2007 and came into force on December 15, 2008. Not all of the Protocol’s measures had effect at that time (more relevant at this point for historical purposes, as all measures are now in force)

II. Fifth Protocol – Important Dates and Interpretive Tools

- Important interpretive sources include the Diplomatic Notes to the Protocol, the U.S. Treasury Department Technical Explanation of the Protocol, the OECD Model Convention and Commentary, and relevant case law
- Treaty changes were substantial in many respects and present a number of planning opportunities and potential pitfalls in the context of cross-border services, migration and investment

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III. Limitation on Benefits / Residency



Limitation on Benefits Clause (Article XXIXA)

- Affects eligibility for benefits under Treaty
- *Principal Policy Rationale:*
To restrict the ability of third-country residents to engage in “treaty shopping”
- Used to only apply to U.S. taxpayers seeking benefits

Limitation on Benefits Clause

LOB Objective Tests:

- **“Qualifying Person”**: Public Company and Ownership / Base Erosion tests
- **“Active Trade or Business”** (entitlement limited to income derived in connection with or incidental to substantial trade or business)
- **“Derivative Benefits”**

LOB Subjective Test:

- As granted by competent authority (entitlement to some or all benefits; no cases to date)

Corporate Residency Changes



Article IV(1) of the Treaty provides:

“...the term ‘resident of a Contracting State’ means any person that, under the laws of that State, is liable to tax therein by reason of that person’s domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature...”

Corporate Residency Changes



The Protocol introduced revised Paragraph 3 to Article IV of the Treaty. It provides that if a corporation is considered resident of both Contracting States (e.g., incorporated in one state with management in the other), then that corporation's status is determined as follows:

- If it is created and existing under the laws of only one Contracting State, it will be deemed resident of that Contracting State; **or**

Corporate Residency Changes



- If the above does not apply (e.g., dual incorporation), the competent authorities may decide the question of residence by mutual agreement. If no agreement is reached (none to date), the subject company shall not be considered a resident of either country for purposes of claiming any of the benefits available under the Treaty
- Effective September 18, 2000 (per prior agreement between the countries)

Corporate Residency Changes

*Future uses of
dually incorporated
companies...*



The Canada – US Tax Treaty Protocol: Impacts and Planning Opportunities

IV. Select Cross-Border Investment Issues



Fiscally Transparent Entities – Definitions

The CRA has provided the following commentary with respect to the interpretation of the term **fiscally transparent entity** (“FTE”) as found in Article IV of the Treaty:

An entity is considered fiscally transparent if “...the income it earns is taxed at the beneficiary, member or participant level. Entities that are subject to tax, but with respect to which tax may be relieved under an integrated system, are not considered fiscally transparent.”

Examples of “fiscally transparent” entities under US tax law	Example of “fiscally transparent” entities under Canadian tax law
<ul style="list-style-type: none">• LLCs that do not “check the box”• Grantor trusts• Common Investment trusts under <i>Internal Revenue Code</i> §584• Partnerships• Unlimited Liability Companies	<ul style="list-style-type: none">• Partnerships• “Bare” trusts

Fiscally Transparent Entities – Article IV(6)

U.S. Limited Liability Companies (“LLCs”)

- Pre-Protocol, most LLCs did not (according to CRA) qualify as “residents of the U.S.” for Treaty purposes (CRA viewed them as corporations but not U.S. residents, since LLCs were, in the absence of any election to the contrary, not liable to comprehensive taxation per the principles enunciated by the SCC in *Crown Forest*)
- The CRA’s Pre-Protocol position was called into question by *TD Securities* decision in 2010
- Per Paragraph 6 of Article IV, Treaty benefits are potentially available on income, profit or gains “derived” by such LLCs with U.S. qualifying members

Fiscally Transparent Entities – Article IV(6)

U.S. Limited Liability Companies (“LLCs”)

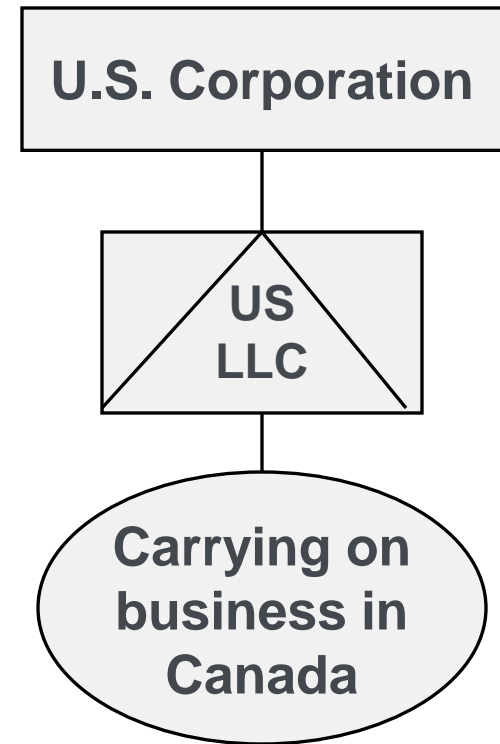
- Key requirement in Article IV(6) is that income amount be subject to the “same treatment” for U.S. tax purposes as would have resulted had the U.S. LLC member derived the income directly (i.e. same **quantum, character and timing**)
- Implications and compliance requirements for U.S. investment into Canada making use of LLCs (including where LLC has non-U.S. or individual members)



Fiscally Transparent Entities – Article IV(6)

Use of LLC as Canadian Business Vehicle

- Treaty branch tax rate only available if income is considered (for U.S. tax purposes) to be “derived” under Article IV(6) by the U.S. corporation and the “same treatment” test is satisfied
- See CRA Document 2009-0339951E5 and CRA Document 2010-0355661E5
- In context of LLCs with U.S. individual members, see CRA Document ITTN No. 44 (April 14, 2011)



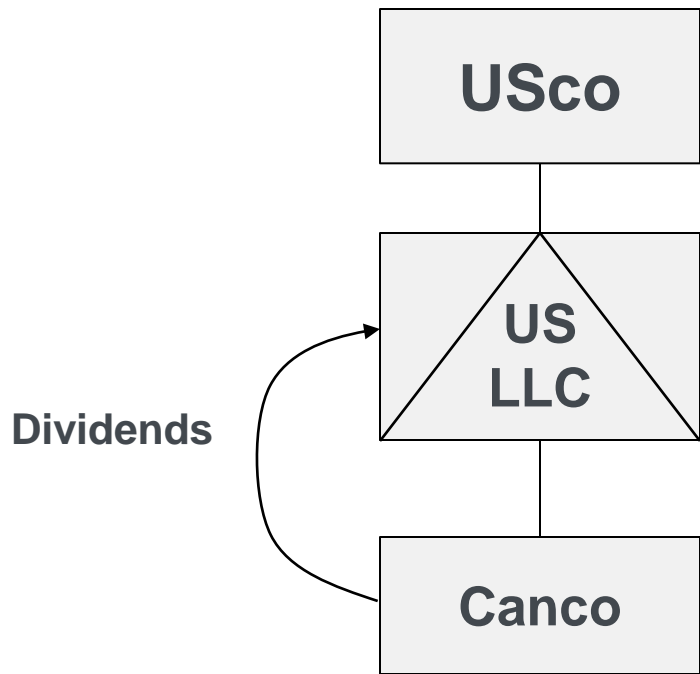
Fiscally Transparent Entities – Article IV(7)

- The Protocol adds Paragraph 7 to Article IV, which can operate to deny Treaty benefits for income received from, or derived through, certain hybrid entities where the “same treatment” test is not satisfied by reason of the entity not being treated as fiscally transparent in the residence state
- Rule took effect on January 1, 2010

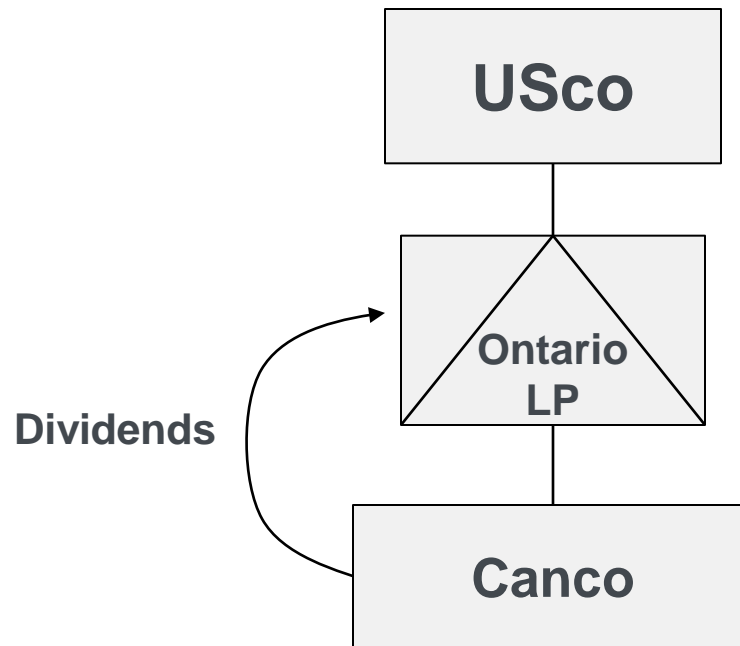
Fiscally Transparent Entities – Article IV(7)(a)

- Paragraph 7(a) may deny Treaty benefits to U.S. owners of reverse hybrid entities (i.e. FTE for Canadian purposes, corporation for U.S. purposes) or Canadian owners of LLCs
- Provides that income, profit or gain in the “source” state shall not be considered to have been paid to or derived by a person resident in the other state if:
 - That person is considered under the laws of the source state to have derived the amount through an entity that is not a resident of the residence state; and
 - By reason of that entity not being treated as fiscally transparent by the residence state, the treatment of the amount under the laws of the residence state is not the same as its treatment would be if that amount had been derived directly by the person

Fiscally Transparent Entities – Examples



USco entitled to 5% dividend withholding tax rate, per Article IV(6)



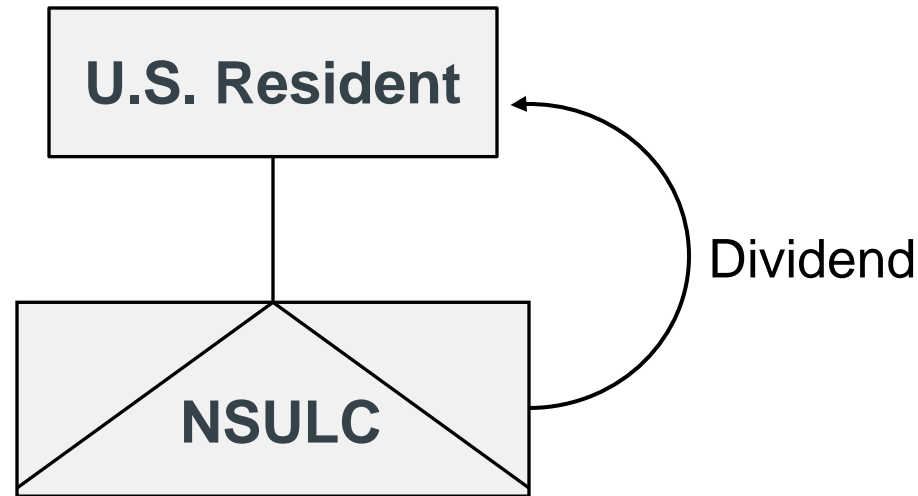
USco not entitled to the 5% Treaty rate on dividends, per Article IV(7)(a)

Fiscally Transparent Entities – Article IV(7)(b)

- Paragraph 7(b) operates to deny Treaty benefits to owners of certain hybrid entities
- Targeted at, among other things, amounts paid to a U.S. resident by a Canadian resident hybrid entity (e.g. Nova Scotia unlimited liability company)
- Specifically, income, profit or gain shall be considered not to be paid to or derived by a resident if:
 - That person is considered under the laws of the source state to have derived the amount from an entity that is a resident of the source state *and*
 - By reason of that entity being treated as fiscally transparent by the residence state, the treatment of the amount under the laws of the residence state is not the same as its treatment would be if that entity was not fiscally transparent under the laws of the residence state (the “**Same Treatment Test**”)

Fiscally Transparent Entities – Article IV(7)(b)

Example:



Canada views the NSULC as a Canadian resident and the U.S. resident as having received a dividend under Part XIII of the ITA. However, because the U.S. would view the distribution differently in the event the NSULC were not disregarded, the “Same Treatment Test” is not satisfied (and Treaty benefits are accordingly denied)

Fiscally Transparent Entities – Article IV(7)(b)

The Technical Explanation provides a number of additional examples regarding the application of Article IV(7)(b) including:

- U.S. corporation is the sole owner of a Canadian unlimited liability company (“**ULC**”), which is disregarded for U.S. tax purposes but is a taxable entity for Canadian tax purposes
- If the U.S. corporation loaned funds to the ULC, interest payments from the ULC to the U.S. corporation would be disregarded for U.S. tax purposes
- Conclusion: The U.S. corporation would not be entitled to any Treaty benefits for the interest payment (i.e. the statutory withholding rate of 25% would apply) by virtue of Article IV(7)(b)

Fiscally Transparent Entities – ULCs

Possible Workaround in case of Profit Repatriations:

Step One:

- Sole member ULC increases the stated capital and thus the “paid-up capital” of its shares
- Canadian withholding tax applies on the resulting “deemed dividend” (of particular significance, the U.S. treats such paid-up capital increase as a “nothing”, regardless of whether the ULC is an FTE); thus, the Same Treatment Test is satisfied

Fiscally Transparent Entities – ULCs

Possible Workaround in case of Dividends:

Step Two:

- The stated capital of the ULC's shares is decreased by the same amount and distributed to U.S. Shareholders (generally paid-up capital returns are not subject to Canadian withholding tax)

Conclusion

The CRA has taken the position that neither Paragraph 7(b) of Article IV nor GAAR would apply to this arrangement, **provided** the ULC is distributing what can reasonably be viewed as “active business” earnings

Fiscally Transparent Entity Rules

– Other Planning Techniques

- Alternative structures to consider in circumstances where Protocol changes are problematic (e.g. branch, partnership, LLC)
- If using an ULC is important from a U.S. tax perspective (e.g., for U.S. foreign tax credit planning purposes or from a Canadian perspective (Regulation 105)) and there are no other satisfactory alternatives, consider a corporate “blocker” in a third jurisdiction (e.g., Luxembourg) such that benefits may be claimed under an appropriate alternative tax treaty
- CRA has ruled favourably on such structures (see CRA Document 2009-0343641R3)

Interest Payments / Financing Strategies

Interest Withholding Tax Changes

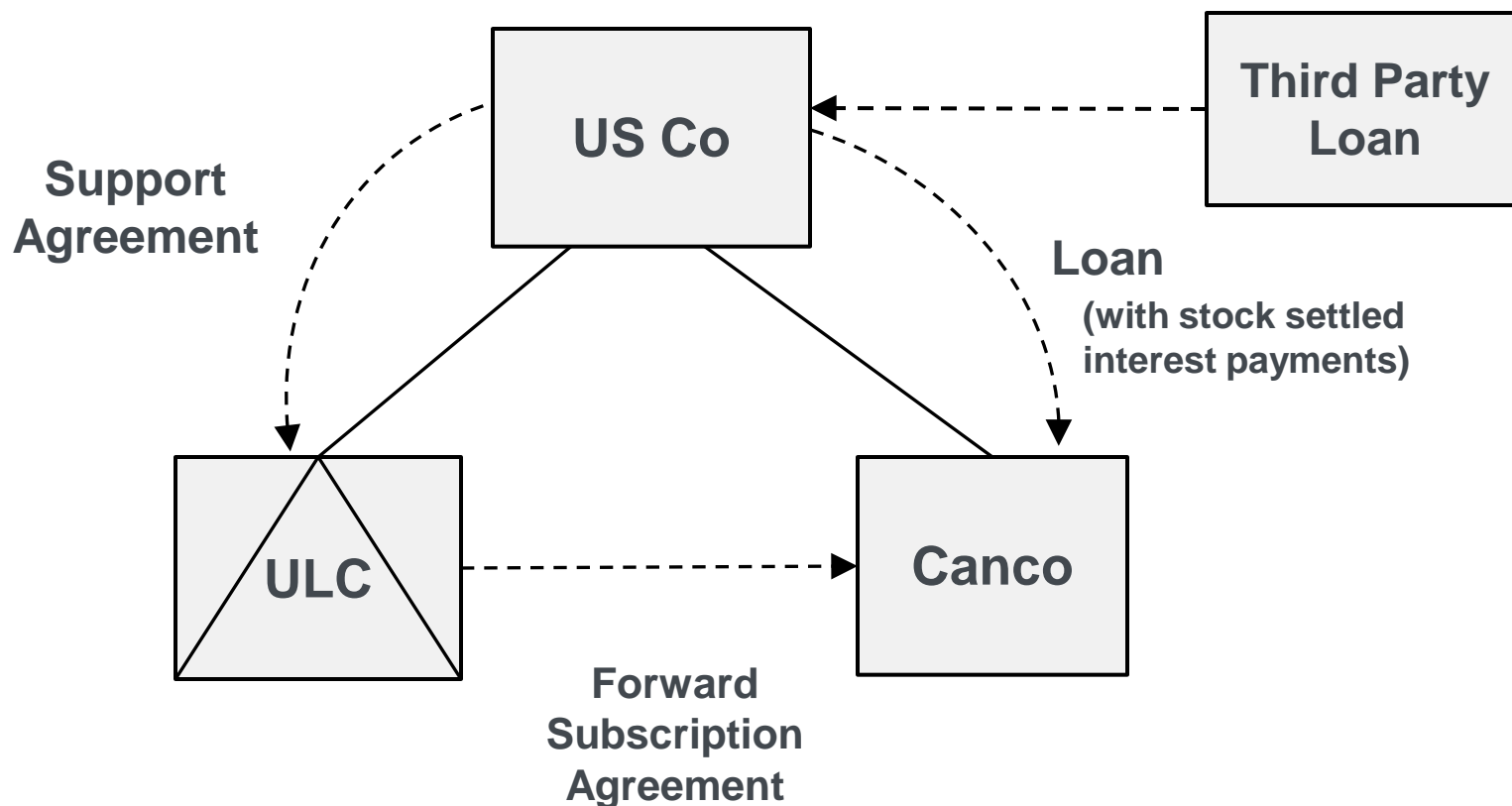
- Related-party interest exemption potentially available under Article XI of the Treaty after January 1, 2010 (however, not applicable to “participating” interest)
- General domestic exemption under ITA from withholding tax on interest paid to arm’s length non-resident persons (again, with the exception of “participating” interest)

Inbound Financing Strategies

- Alternative strategies for tax-effective U.S. financing of Canadian acquisitions and ongoing working capital requirements have arisen as a result of the measures contained in the Protocol (certain traditional structures are no longer viable)
- In particular, hybrid instruments, e.g. instrument(s) classified as debt under one country's tax laws and equity for purposes of another country's tax laws have gained popularity

Inbound Financing Strategies

– Simplified Hybrid Debt Structure



Inbound Financing Strategies

– Simplified Hybrid Debt Structure

Intended Results

- Interest expense generally deductible for Canadian purposes
- Dividend for U.S. purposes only to extent out of “E&P”; otherwise, basis reduction
- Treaty should eliminate withholding tax on interest paid by Canco
- U.S. parent deducts interest on third-party loan

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V. Cross-Border Services / Stock Option Benefits



New Permanent Establishment Rules for Service Providers



Pre-Protocol Rules / Case Law:

- Traditional “**permanent establishment**” (“**PE**”) (Article V) and “**fixed base**” (Article XIV) concepts
- A U.S. resident service provider’s income from independent contractor services provided in Canada was taxed only to the extent the income was attributable to a “fixed base” in Canada that was “regularly available” to the U.S. resident and through which the U.S. resident carried on his/her/its business
- *Dudney* (FCA) decision did not sit favourably with CRA

New Permanent Establishment Rules for Service Providers



Protocol Changes

- “Fixed Base” concept eliminated (merged with PE definition and Article VII “business profits” provisions, consistent with OECD Model Convention’s recognition that there is “no practical distinction between the two concepts”), such that PE provisions now apply to individuals
- Definition of PE is expanded to include a deeming rule with respect to certain service providers who do not otherwise have a fixed place of business in the country where the services are provided/performed

New Permanent Establishment Rules for Service Providers



Protocol Changes

- Pursuant to new Paragraph 9 of Article V, an “enterprise” providing/ performing services in the other state is deemed to have a PE in the other state if (and only if) one of the following conditions is met:
 - a) The services are performed by an individual who is present in the other state for more than 183 days during any 12-month period and more than 50% of the enterprise’s gross active business revenues (i.e. revenues excluding investment activities) are derived from such services; **or**
 - b) The services are provided in the other state for more than 183 days during any 12-month period and the services relate to the *same project* or a *connected project* for a customer who is either a resident of the other state or who has a PE in the other state (to which the services can be attributed)
- If Article V(9) is applicable, income from the subject services will be taxed in accordance with Article VII (Business Profits)

New Permanent Establishment Rules for Service Providers



- U.S. Treasury Department Technical Explanation: *Article V(9)(a) is intended to apply with reference to the presence of a single individual*
- Meaning of “same or connected project”, per new Article V(9)(b)
 - The Diplomatic Notes included in Annex B to the Protocol (the “**Diplomatic Notes**”) provide that projects will be considered to be “connected” if they constitute a “coherent whole, commercially and geographically” from the service-delivering enterprise’s perspective

New Permanent Establishment Rules for Service Providers



- Factors per U.S. Technical Explanation for “commercial coherence” include:
 - One contract, absent tax considerations, similar work and same individuals
- Geographical coherence example (multi-city bank auditing project)
- Article V(9) is subject to Article V(3), which provides that a “building site or construction or installation project” will only constitute a PE if it lasts longer than 12 months

New Permanent Establishment Rules for Service Providers



Application of Article V(9) – Example:

- CanCo hires a Canadian law firm to perform work in the U.S. The Canadian law firm sends a lawyer to work in the U.S. for greater than 183 days. CanCo pays the law firm an amount that does not exceed more than 50% of the Canadian law firm's gross active business revenues over the period in which the lawyer is present in the U.S.
 - The Canadian law firm would not be found to have provided services through a PE in the U.S. for purposes of Article V(9)(a)
 - If CanCo (as a customer of the Canadian law firm) is not resident in the U.S. and does not have a PE in the U.S., the Canadian law firm will likely not be found to be providing services through a PE in the U.S. for purposes of Article V(9)(b)
- Other Examples (see U.S. Technical Explanation)



Allocation of Stock Option Benefits

Allocation of Stock Option Benefits

- The Diplomatic Notes provide a new rule (for purposes of Article XV and XXIV) applicable to situations where an employee is granted a stock option while resident in one country but exercises it while resident in the other country (while remaining at all times with the same employer group)
- Specifically, Paragraph 6 of the Diplomatic Notes provides that each country can only tax the amount of the option benefit that is equal to the number of days that the employee's **principal place of employment** was in that country, during the period between the day the option was granted and the day the option was exercised, divided by the number of days in that period

Allocation of Stock Option Benefits

Paragraph 6(a) of the Diplomatic Notes is subject to Paragraph 6(b), which allows the competent authorities to agree to a different allocation method where “...*the terms of the option were such that the grant of the option should be appropriately treated as a transfer of ownership of the underlying securities*”

Allocation of Stock Option Benefits

CRA commentary on the definition of the phrase “principal place of employment”:

“The Contracting State in which the employee was physically present while exercising the employment on a particular day”

Allocation of Stock Option Benefits

Example provided by the CRA

- January 1, 2009 – employee granted option to acquire 1000 shares of capital stock of her employer
- December 31, 2009 – employee exercised the option and realized a benefit of \$100,000
- During the year, the employee worked 100 days in Canada and 150 in the U.S.

Allocation of Stock Option Benefits

Example provided by the CRA

- If Paragraph 6(b) of the Diplomatic Notes does *not* apply (no such cases so far) then:
 - \$40,000 of the stock option benefit would be determined to arise from the individual's employment in Canada
 - \$60,000 of the stock option benefit would be determined to arise from the individual's employment in the U.S.

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Concluding Comments





Questions?

THANK YOU

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Notes / Disclosures

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