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

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The Canada – US Tax Treaty: Impacts and Planning Opportunities

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III. Limitation on Benefits / Residency

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I. General Principles

I. General Planning Principles

- Avoiding Double Taxation
- Residence
- Sourcing of Income

I. General Planning Principles

- Pass-Through Structures
- Deferral Structures

I. General Planning Principles

- Entity Classification
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- Repatriation Techniques

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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 of Benefits / Residency

Limitation of 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”

Limitation of Benefits Clause

LOB Objective Tests:

- "**Qualifying Person**": Natural 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
- Guidelines for requesting a determination letter available at International Tax Directorate Publication # 2009-05-22 (May 22, 2009)

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 <u>only one</u> 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...

Treaty Shopping

- Budget 2014 includes a proposed a “treaty shopping” rule that may affect investments using a third jurisdiction.
- The rule would deny treaty benefits where a main purpose of a transaction was to obtain such treaty benefits (the “**Main Purpose Test**”).
  - Main purpose presumed where person resident in a treaty country acted as a conduit (the “**Conduit Presumption**”)
- There are two relieving provisions:
  1. Safe harbour presumption: for active business, lack of benefit to controlling person, or publicly traded companies
  2. Discretionary relieving provision

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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**
• LLCs that do not “check the box” • Grantor trusts • Common Investment trusts under *Internal Revenue Code* §584 • Partnerships • Unlimited Liability Companies • “S” Corporations	• Partnerships • “Bare” trusts

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Fiscally Transparent Entities – Article IV(6)

U.S. Limited Liability Companies ("LLCs")

- Pre-Protocol, most LLCs did not qualify as "residents of the U.S." for Treaty purposes (CRA viewed LLCs as corporations but not U.S. residents, since the LLC was not itself liable to comprehensive taxation per the principles enunciated by the SCC in *Crown Forest*)
- CRA's Pre-Protocol position called into question by *TD Securities* decision
- 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)

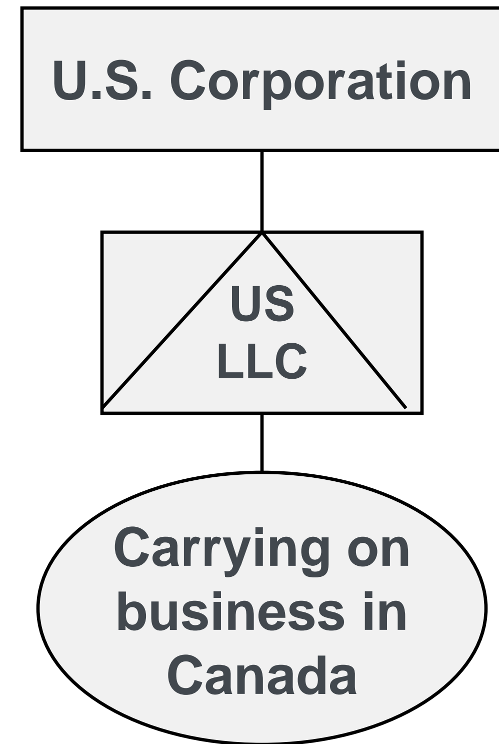
U.S. Limited Liability Companies ("LLCs")

- 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 using LLCs (including where LLC has non-U.S. or individual members)

Fiscally Transparent Entities – Article IV(6)

LLC as Canadian Business Vehicle

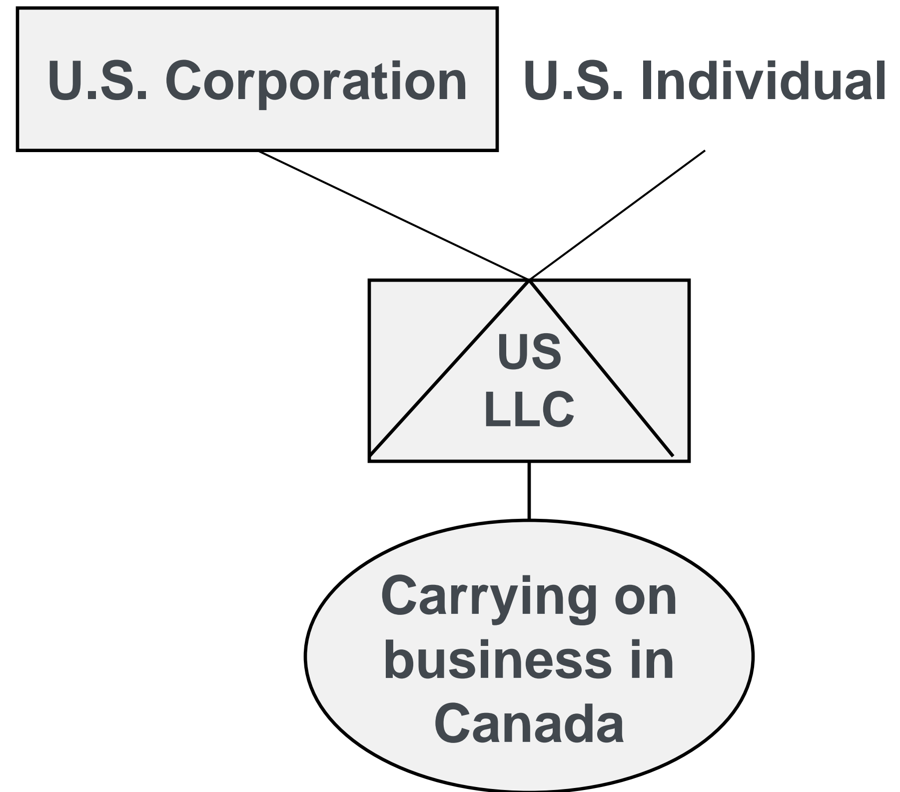
- Treaty branch tax rate only available if income is considered (for U.S. tax purposes) to be "derived" under Article IV(6) by the U.S. corporation and the same treatment test is satisfied
- See CRA Document 2009-0339951E5



Fiscally Transparent Entities – Article IV(6)

LLC with Individual Members

- Article X(6) limits additional tax on "companies" carrying on business in Canada to 5%
- CRA's *public* view is that X(6) does not reduce the branch profit tax on non-corporate members
- See CRA Document ITTN No. 44 (April 14, 2011) and 2012-0440101E5 (October 23, 2012)
- This arguably violates the non-discrimination provisions



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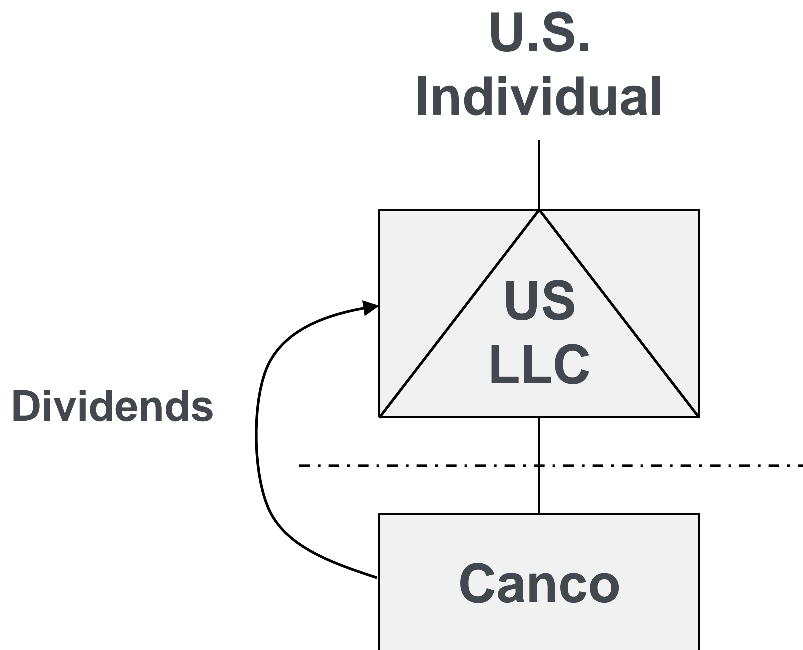
Fiscally Transparent Entities – Article IV(7)

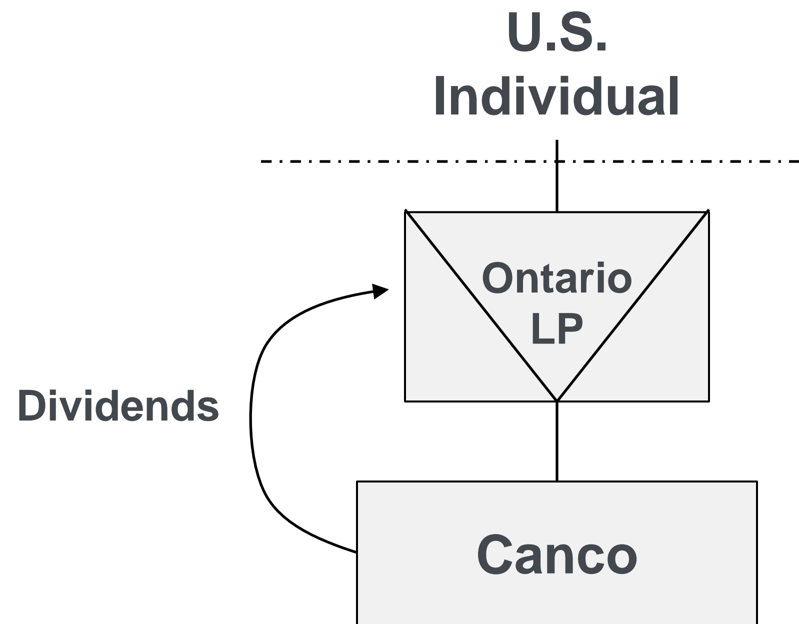
- The Protocol adds Paragraph 7 to Article IV, which can operate to deny Treaty benefits for income received from or derived through certain hybrid entities where the "same treatment" test is not satisfied by reason of the entity not being treated as fiscally transparent in the residence state
- Rule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





US individual entitled to 15% dividend withholding tax rate, per Article IV(6)

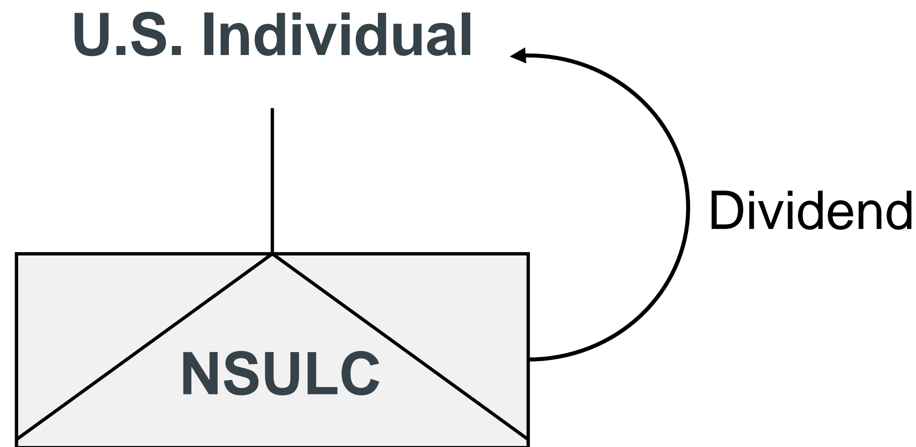
US individual not entitled to the 15% Treaty rate on dividends, per Article IV(7)(a)

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. individual 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)

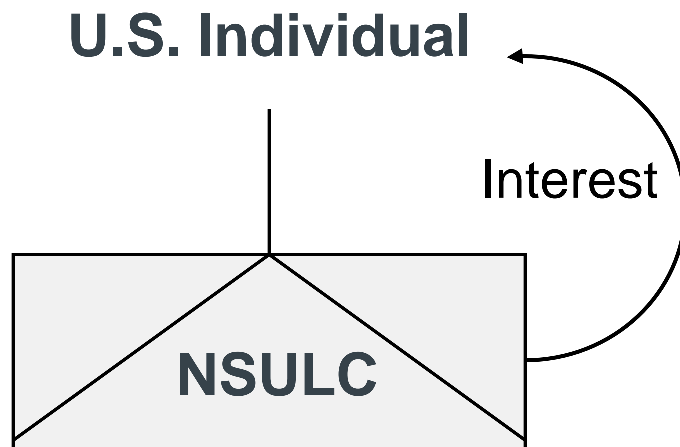
Fiscally Transparent Entities – Article IV(7)(b)

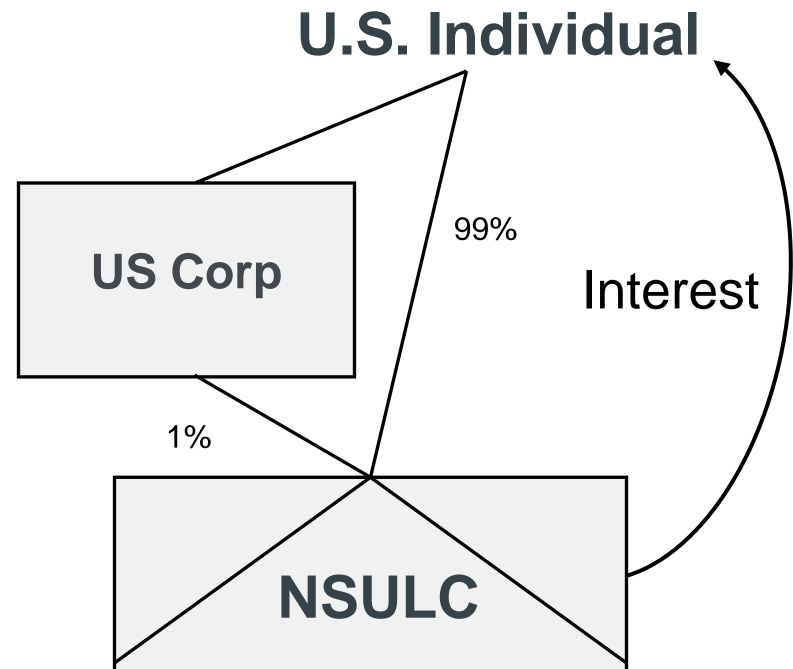
The Technical Explanation provides a number of additional examples regarding the application of Article IV(7)(b) including:

- 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 – Article IV(7)(b)

Examples:





US Individual would be ineligible for treaty benefits under Article IV(7)(b)

US Individual would not be ineligible for treaty benefits under 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. U.S. foreign tax credit planning or 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)
- Budget 2014 "treaty shopping" proposals may limit such planning in the future.

Interest Payments / Financing Strategies

Interest Withholding Tax Changes

- Related-party interest exemption potentially available under Article XI of the Treaty after January 1, 2010 (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)
- Additional measures in recent years limiting interest deductibility under "thin-capitalization" regime

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 hybrid 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

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V. Cross-Border Services / Stock Option Benefits / Pensions

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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

- 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*"

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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 (cont'd)

- 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.

Pensions

- Traditionally, pension plans were generally accorded favourable tax treatment only in the country of employment.
- Amendments to Article XVIII facilitate certain cross-border contributions to qualifying retirement plans (“**QRPs**”) on behalf of:
  - individuals engaged on a short-term cross-border employment assignment, and
  - Individuals employed in a cross-border (commuter) employment arrangement.
- Changes to Article XVIII also addressed certain concerns of U.S. citizens residing in Canada

QRPs in Canada and the U.S.

- Canadian plans
  - Registered Pension Plans (RPPs)
  - Group Registered Retirement Savings Plans (RRSPs)
  - Deferred Profits Sharing Plans (DPSPs)
  - Certain Registered Retirement Income Funds (RRIF) and RRSPs funded exclusively by rolling over contributions from the above plans
  - *not* Retirement compensation arrangements (RCAs)
- U.S. plans (among others)
  - Tax sheltered retirement plans, 401(k)
  - Plans under Sec. 401(a)
  - Simplified employee pension plans, 408(k)
  - Simple retirement accounts, 408(p)
  - Qualified annuity plans and trusts, and the Thrift Savings Fund

Pensions – Assignments

- A Canadian employer can generally claim a deduction from its Canadian taxes in respect of contributions to a U.S. expat's QRP (and the U.S. expat will generally be entitled to a corresponding deduction from Canadian taxes) if the expat:
  - Was a non-resident of Canada prior to the assignment in Canada
  - Was already a member of the U.S. QRP
  - Was on assignment for less than 60 of the previous 120 months
  - Was subject to tax in Canada while on assignment and the contributions and benefits to the QRP are attributable to such services in Canada
  - Did not contribute to any other QRP in Canada during the year

Pensions – Assignments

- Deductions limited to the lesser of:
  - Contributions attributable to services performed in Canada
  - Amount that would have been allowed under U.S. domestic law
- Similar rules apply to Canadian expats in the U.S.

Pensions – Commuters

- To claim a deduction in the home country for a contribution to a QRP in the source country (country of employment):
  - Individual must be taxable in the source country
  - Individual must be paid by a resident/PE of the employer in the source country
  - Contributions must be attributable to services in the source country
  - Contributions must be deductible in the source country
  - Further limited by existing deduction limits (i.e., RRSP deduction limit)

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VI. Departure Tax

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Departure Tax

- Canada deems taxpayers to have disposed of certain assets on emigration.
- This may result in a capital gain for Canadian tax purposes at the time of departure.
- Risk of double taxation if U.S. calculates capital gain on subsequent disposition using original cost basis.
- Article XIII was amended to limit instances of double taxation by permitting taxpayers to “bump” the ACB of property at the time of departure.

Departure Tax – Election

- Fifth Protocol provides an election:
  - Individual departing from Canada to the U.S. may elect to create a deemed disposition for U.S. tax purposes
  - If the individual is not subject to U.S. tax at time of departure, election simply adjusts cost basis to FMV
  - If the individual is subject to U.S. tax at time of departure, the disposition would generally be reported for U.S. tax purposes and could give rise to a capital gain.
  - The individual would generally be entitled to claim a foreign tax credit to minimize double taxation

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Departure Tax – Election, cont.

- Election must be made for all assets subject to departure tax in Canada
- Basis bump is only available if there is a net gain from the deemed disposition

Questions?

THANK YOU

Notes / Disclosures

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These materials do not constitute legal advice and cannot be relied upon for the purpose of avoiding federal tax penalties.

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