tax law bulletin

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New Protocol to the Canada-US Tax Treaty: "Treaty Shopping" Limitations Expanded

While certain features of the recently released Fifth Protocol to the Canada-US Income Tax Convention (the "**Treaty**") were previously announced by the Minister of Finance in the 2007 federal budget, several unexpected elements of the new protocol may have dramatic implications for US-resident entities that transact business in Canada or receive payments from Canadian sources. Of special note, the inclusion of a comprehensive bilateral "limitation on benefits" clause in the new protocol may fundamentally restrict the circumstances under which the Canadian tax benefits of the Treaty may be claimed.

Background

In 1995, the Treaty was amended with the enactment of a protocol that introduced a new "limitation on benefits" article (the "**Initial LOB Article**"). The adoption of the Initial LOB Article came at the insistence of the United States government and reflected the US government's view that all of its treaties should contain expansive limitation on benefits clauses to combat "treaty shopping" and abusive attempts to claim the benefits of a particular tax treaty.

Interestingly, the Initial LOB Article only applied in respect of taxes imposed by the United States, thereby restricting the availability of US Treaty benefits to those residents of Canada that fell within one of several, enumerated categories set out in the Initial LOB Article. Prior to the negotiation of the new protocol, the Canadian government had not insisted on the inclusion of comprehensive limitation on benefits clauses in its tax treaties, relying instead on more limited, treaty-based anti-avoidance provisions, as well as the potential application of the "general anti-avoidance rule" (the "**GAAR**") contained in the *Income Tax Act* (Canada) (the "**Tax Act**") to combat tax avoidance.

A New Approach to Limit "Treaty Shopping" and the Abuse of Tax Treaties?

When the new protocol enters into force, the Treaty will contain the first comprehensive limitation on benefits clause to limit the Canadian tax benefits otherwise afforded by a Canadian tax treaty (the "**Updated LOB Article**"). The Updated LOB Article provides that the benefits of the Treaty will be restricted to those residents of Canada or the US that either: (i) are "qualifying persons" as defined in the Updated LOB Article; or (ii) satisfy one of three specific tests relating to their establishment, operation, or ownership.

"Qualifying Persons"

For the purposes of the Treaty, a "qualifying person" will generally mean a resident of Canada or the United States (as defined in Article IV of the Treaty) that is:

(a) a natural person;

(b) Canada or the US or a political subdivision or local authority thereof, or any agency or instrumentality of either state, subdivision or authority;

(c) 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";[1]

(d) a company, if five or fewer companies or trusts referred to in paragraph (c) above own, directly or indirectly, more than 50% of the aggregate votes and value of the shares of the company and more than 50% of the votes and value of each disproportionate class of shares (other than certain "distressed preferred shares"), provided that each company or trust in the chain of ownership is a "qualifying person" for the purposes of the Treaty;

(e) companies or trusts that are not primarily owned, directly or indirectly, by persons other than qualifying persons,2 provided the amount of the expenses deductible from the gross income of such entities, which are paid or payable, directly or indirectly, to persons other than "qualifying persons", is less than 50% of the relevant entity's gross income for the applicable period (the "**Base Erosion Test**");3

(f) an estate; and

(g) certain not-for-profit or tax-exempt entities.

Other Treaty Benefit Eligibility Tests

Active Trade or Business Test

Where a resident of the United States is not a "qualifying person" for the purposes of the Treaty, the resident may still be entitled to claim certain of the Canadian tax benefits provided under the Treaty where that person, or a person related thereto, is engaged in the active conduct of a trade or business in the US. To the extent that such an active trade or business is undertaken in the US, Treaty benefits may be available in respect of income derived by the US resident in Canada "in connection with or incidental to that trade or business" (including any such income derived directly or indirectly by that person through one or more other persons that are resident in Canada), but only if that trade or business is "substantial" in relation to the activity carried on in

[1] The Updated LOB Article contains special interpretative rules that define what constitutes a "principal class of shares", a "disproportionate class of shares" and a "recognized stock exchange".

The term "principal class of shares" of a company will generally mean the ordinary or common shares of the company, provided that such class of shares represents the majority of the voting power and value of the company. If no single class of ordinary or common shares represents the majority of the aggregate voting power and value of a company, the "principal class of shares" will be considered to be those classes that, in the aggregate, represent the majority of the aggregate voting power and value of the company.

The term "disproportionate class of shares" will mean any class of shares of a company resident in the US or Canada that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the country in which the company is not resident by particular assets or activities of the company (i.e., "tracking securities").

Finally, the term "recognized stock exchange" will capture a host of Canadian and international stock exchanges, including those that are "prescribed stock exchanges" (such as the Toronto Stock Exchange) or "designated stock exchanges" under the Tax Act.

While the concepts of a "principal class of units" or a "disproportionate class of units" are not explicitly defined in the Updated LOB Article, such phrases should presumably be interpreted in a manner that is consistent with the definitions of a "principal class of shares" and a "disproportionate class of shares" set out in the new article. The concept of "regular" trading activity is also undefined and may prove to be the source of some interpretive challenges in the future.

[2] For the purposes of this test, (i) in the case of a company, at least 50% of the aggregate votes and value of the shares, as well as at least 50% of the votes and value of each disproportionate class of shares (other than certain "distressed preferred shares"), and (ii) in the case of a trust, at least 50% of the beneficial interests, as well as 50% of each disproportionate interest, must be owned, directly or indirectly, by qualifying persons.

[3] The deductibility of expenses will be determined in accordance with the rules applicable in the country of residence of the relevant company or trust. The applicable period will be the entity's preceding fiscal period (or the entity's current fiscal period, if it is newly formed).

Canada giving rise to the income in respect of which Treaty benefits are claimed. For the purpose of applying the active trade or business test, a business of making or managing investments is excluded, unless the relevant 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.

Derivative Benefits Test

To the extent that a US company does not constitute a "qualifying person", it may also still be entitled to claim the benefits of the Treaty in respect of the receipt of dividends, interest and royalties if: (i) the company does not run afoul of the Base Erosion Test, and (ii) shares of the company that represent more than 90% of the aggregate votes and value of all the company's shares are owned, directly or indirectly, by persons each of whom is a qualifying person or a person who satisfy certain eligibility criteria (as more particularly set out below).4 A person who is not a qualifying person will satisfy the eligibility criteria set out as part of the Derivative Benefits Test if:

(a) the person is a resident of a country with which Canada has entered into a comprehensive income tax treaty and is entitled to all of the benefits provided by Canada under that treaty;

(b) the person would qualify for benefits under the Treaty if that person were resident in the US by virtue of being a "qualifying person" or by satisfying the active trade or business test set out above (assuming, for the purposes of applying the active trade or business test, the business carried on by the person in its country of residence were carried on in the US); and

(c) the person would be entitled to a rate of tax in Canada under the treaty between that person's country of residence and Canada, in respect of the particular class of income for which benefits are being claimed under the Treaty, that is at least as low as the rate applicable under the Treaty.

[4] In addition, at least 50% of the votes and value of any disproportionate class of shares (other than certain "distress preferred shares") must be owned by such persons.

Competent Authority Relief

Where the Updated LOB Article would otherwise preclude a resident of Canada or the United States from claiming the benefits afforded by the Treaty, the resident may apply to the "competent authority" of the other contracting state (i.e., the Canada Revenue Agency (the "**CRA**") with respect to the denial of Canadian Treaty benefits) to determine, on the basis of all factors, including the history, structure, ownership and operations of the applicant, whether:

(a) its creation and existence did not have as a principal purpose the obtaining of benefits under the Treaty that would not otherwise be available; or

(b) it would not be appropriate, having regard to the purpose of the Updated LOB Article, to deny the benefits of the Treaty to that person.

Where the relevant competent authority determines that either of the foregoing tests are satisfied, the foreign resident may be granted the benefits of the Treaty.

Domestic Anti-Avoidance Rules

The enactment of the Updated LOB Article will not preclude the CRA from asserting that domestic anti-avoidance rules contained in the Tax Act, including the GAAR, may be applied to disallow the Canadian tax benefits otherwise afforded by the Treaty. The Updated LOB Article affirms that the article is not to be construed as restricting, in any manner, the right of the Canadian government to deny Treaty benefit where "it can reasonably be concluded that to do otherwise would result in an abuse of the provisions" of the Treaty. However, in light of the recent lack of success of the CRA in disallowing treaty benefits on the basis of the GAAR, the CRA may be reluctant to bring forth GAAR reassessments in cases where the Updated LOB Article may be applicable.

Future Implications of the Updated LOB Article

The Updated LOB Article may be applied to disallow the tax benefits associated with taxes withheld at source (such as non-resident withholding taxes) in respect of amounts paid or credited on or after the first day of the second month that begins after the date on which the new protocol enters into force. In respect of all other taxes, assuming the new protocol is not fully ratified prior to the beginning of 2008, the Updated LOB Article will apply to taxable years that begin after the calendar year in which the new protocol enters into force. Accordingly, it is expected that the Updated LOB Article may apply to disallow the availability of reduced rates of withholding tax as early as the spring of 2008 and, more generally, in respect of all taxes by 2009.

The enactment of the Updated LOB Article may have dramatic implications for any multi-national enterprise that transacts business in Canada. All Canadian entities that conduct business with, or make payments to, US parties would be well advised to reassess the Canadian tax treatment of their cross-border arrangements in light of the potential application of the Updated LOB Article.

A Cautionary Note

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

About McMillan LLP's Tax Law Group

Our Tax Law Group ranks among the best in Canada and includes individuals who have been recognized internationally as leading advisers in The Martindale-Hubbell Legal Directory and The Canadian Legal LEXPERT Directory. Always sensitive to our clients' business objectives, we provide comprehensive and pragmatic Canadian tax advice on a wide variety of matters, including corporate reorganizations, mergers and acquisitions, securities, structured financing and derivative products, leasing, and cross-border transactions. Routinely advising clients on compliance matters, we are experienced in negotiating disputes with revenue authorities and litigating tax issues.

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