

INTERNATIONAL CORPORATE STRUCTURES AND THE NEW PROTOCOL TO THE CANADA-U.S. INCOME TAX CONVENTION

*By Martha O'Brien**

The Third Protocol to the Canada-United States Income Tax Convention, 1980¹ (hereinafter the "Protocol" and the "Convention" respectively) was ratified on November 9, 1995 and became effective, for the majority of its provisions, on January 1, 1996.² While in general the Protocol reduces tax barriers to trade and investment between Canada and the U.S. for both individuals and corporations, complex new limitation on benefits or "anti-treaty shopping" rules could have severe and unanticipated effects for some Canadian trusts and corporations. This article will analyze new Article XXIX A of the Convention as it applies to Canadian resident corporations, and describe some of the practical effects and pitfalls that corporate and commercial, as well as tax lawyers, will want to be aware of when advising their clients who have U.S. interests or who are planning expansion into the U.S.

BACKGROUND TO TAX TREATIES

Canada has approximately 60 bilateral taxation conventions or treaties, the objectives of which include the encouragement of trade between Canada and the other Contracting State by prevention of double taxation of the same taxpayer in respect of the same income by both Contracting States. Double taxation typically occurs when a person is considered, according to the respective domestic laws of the Contracting States, to be subject to taxation in both Contracting States, or where a resident of one Contracting State has income derived in the other Contracting State that is taxable by that other State.

The benefits of tax treaties are generally available to individuals, corporations and other entities which are residents of the Contracting States. The issue of residence is one which could be, and has been, the exclusive subject of papers much longer and more detailed than this one. For the purpose of this discussion, the important rule is that a corporation incorporated in Canada after April 26, 1965, or, if incorporated before April 27, 1965 and which has in any year been resident in or carried on business in Canada, or which has been continued in Canada,³ is a resident of Canada under Canadian law and the Convention, even where it is managed or controlled outside of Canada.

A critical provision in most tax treaties is a "tie-breaker" rule, which ensures that a taxpayer is resident, and therefore taxable on world income, in only one of the Contracting States. Another typical treaty benefit is reduced rates of income tax imposed by the Contracting State of source on dividends, branch profits, interest and royalties paid to a resident of the other Contracting State. Certain types of cross-border income may be exempted from tax in either the country of source or the country of residence.

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Where there is no applicable tax treaty, Canada imposes a general income tax (or withholding tax) of 25% on the income of non-residents that has its source in Canada.⁴ The U.S. general withholding tax rate is 30%.⁵

EFFECT OF THE PROTOCOL

Under the Convention, withholding tax rates were already reduced to 10 or 15 percent on most cross-border payments between the U.S. and Canada. The Protocol significantly reduces withholding tax rates on cross-border direct dividends,⁶ branch profits⁷ and interest,⁸ and expands the categories of royalties⁹ and interest payments¹⁰ that are exempt from withholding tax. However, the Protocol also contains provisions that deny treaty benefits to certain Canadian resident corporations and trusts that up to now have been entitled to treaty benefits.¹¹ Where treaty benefits are denied, these Canadian corporations and trusts will be subject to a doubling or tripling of the withholding tax imposed on their U.S. source income. Since Canada provides a foreign tax credit (or, alternatively, a deduction from income) that allows a Canadian resident to deduct foreign tax paid from the Canadian tax that would otherwise be payable on the same income, only in a few circumstances will denial of treaty benefits ultimately result in higher total Canadian and U.S. tax payable. However, there could be severe cash flow consequences for Canadian businesses that lose their entitlement to treaty benefits under the Protocol, particularly if the imposition of higher withholding tax rates was unanticipated.

A comparison of the pre-1996 Convention withholding tax rates and the Protocol withholding tax rates is set out below.

	Pre-1996	1996	1997 and after
Dividends ¹²			
a. direct	10%	6%	5%
b. portfolio	15%	15%	15%
Branch Profits	10%	6%	5%
Interest	15%	10%	10%
Royalties ¹³	10%	10%	10%

THE LIMITATIONS ON BENEFITS PROVISIONS

General

As mentioned above, the limitation on benefits, or anti-treaty shopping provisions in Article XXIX A of the Protocol effectively deny the benefits of the Convention to certain Canadian residents which previously were entitled to treaty benefits. There is no reciprocal provision denying benefits to certain U.S. residents. The technical explanation¹⁴ to the Protocol, prepared by the U.S. Treasury Department and accepted by the Minister of Finance for Canada as accurately reflecting understandings reached in the course of negotiations as to the interpretation and application of the Protocol, states that Canada prefers to combat treaty-shopping abuses by relying on general anti-avoidance rules.¹⁵

Treaty shopping is generally understood to refer to the use of conduit entities, such as corporations, partnerships or trusts, resident in a country that has an advantageous tax treaty with the country where business or investment is to be undertaken, by persons who are not residents of a Contracting State and therefore would not otherwise be entitled to the treaty benefits. For example, a company incorporated in Canada, owned and controlled by residents of the Cayman Islands, and doing business in the U.S., would, prior to the coming into force of the Protocol, be entitled to the benefits of the Convention in respect of its U.S. source income, even though the company is controlled by residents of a tax haven. The appropri-

ateness of denial of treaty benefits in this kind of situation is not contentious. However, the anti-treaty shopping rules in the Protocol may apply in situations where there is no treaty shopping intention or effect and no actual abuse of the Convention can be demonstrated. Even some corporations that are entirely Canadian owned may be affected.

Another objection to the limitation on benefits ("LOB") provisions is their complexity and ambiguity. The technical explanation will be of some assistance in interpreting and applying the LOB rules, but there remain a great number of issues that are unresolved. For Canadians and their advisors, a significant obstacle is the fact that the LOB rules are to be interpreted according to the domestic tax law of the U.S.,¹⁶ which is unfamiliar to Canadians and is much more complex than Canadian tax law, both in its actual provisions and in the way it is interpreted and applied administratively and judicially.

The LOB provisions in the U.S.-Netherlands Convention¹⁷ are very similar to those in the Protocol. However, the U.S.-Netherlands rules are accompanied by numerous specific definitions for terms that are general or ambiguous in the Protocol. While it may in some circumstances be useful to compare the U.S.-Netherlands provisions in attempting to interpret the Canadian LOB rules, it should be remembered that the absence of specific definitions in the Protocol may indicate lack of agreement on such definitions during prolonged negotiations, or agreement that the meanings ascribed to various terms by U.S. tax law would apply. By implication, the U.S.-Netherlands definitions are not applicable, although the U.S. authorities may use them as guidelines.¹⁸ Since the U.S. and Canada have agreed that the technical explanation accurately reflects understandings reached during negotiations, it should be more authoritative than the definitions in the Netherlands treaty, even though it is less precise.

The reduced withholding tax rates, are available to three groups of Canadian resident corporations which can be broadly described as follows. The first group is corporations which are "qualifying persons", discussed below. The second group are corporations who carry on related, substantial active businesses in both the U.S. and Canada, through either a U.S. subsidiary or a U.S. branch. The third group are foreign controlled holding or investment corporations where the shareholders are residents of countries that have comprehensive tax conventions with the U.S.

"Qualifying Persons"

New Article XXIX A paragraph 1 provides that qualifying persons shall be entitled to all of the benefits of the Convention, and persons who are not qualifying persons shall not be entitled to *any* benefits of the Convention, subject to the limited exceptions in paragraphs 3, 4 and 6 of Article XXIX A (emphasis added).

Paragraph 2 of Article XXIX A defines "qualifying person" for the purposes of the Convention.¹⁹ The important portions of the definition for this discussion are subparagraphs (a), (c), (d) and (e), which, in plain language, provide that qualifying persons are Canadian residents who are

- i. natural persons;
- ii. most public companies and their Canadian resident, directly or indirectly controlled subsidiaries, provided each corporation in the chain is a qualifying person; and
- iii. Canadian private companies that are controlled (more than 50% by votes and value) by qualifying persons or residents or citizens of the U.S. and which do not pay more than fifty percent of their gross income as deductible expenses to persons which are not qualifying persons or residents or citizens of the U.S.

For simplicity of expression, residents or citizens of the U.S. will be referred to hereafter in this article as "U.S. persons".

Paragraph 5 of Article XXIX A defines "recognized stock exchange" for the purposes of the Article as Nasdaq, a stock exchange registered with the Securities and Exchange Commission as a national securities exchange,²⁰ and the Alberta, Montreal, Toronto, Vancouver and Winnipeg stock exchanges.²¹

There are some notable exclusions from the definition of qualifying person. For example, a joint venture that takes the not uncommon form of a corporation incorporated in Canada, 50 percent owned by a Canadian qualifying company and 50 percent by a foreign company, will not be a qualifying person, even though it will be a Canadian controlled private corporation under the Income Tax Act.²²

A company of which 51 percent of the votes and value are owned directly or indirectly by six (as opposed to five) Canadian qualifying public companies is not a qualifying person, unless it also meets the "base erosion test", described below. The arbitrariness of the limitation on acceptable ownership to five public qualifying companies is inexplicable, since treaty shopping concerns are addressed by the requirement that where the Canadian subsidiary is indirectly owned, each corporation or trust in the chain must be a qualifying person or U.S. resident.

The Base Erosion Test

The base erosion test is fundamental to the LOB rules for private corporations and is essentially a comparison of deductible expenses to gross income. If deductible expenses paid to persons who are neither qualifying persons nor U.S. persons exceed 50 percent of gross income, the base erosion test will not be met. The idea is that even if the shares of a company are controlled by Canadians, if the earnings of the corporation flow to persons who are neither Canadians nor Americans, there is potential for treaty shopping abuse.

"Gross income" and "deductible expenses" are not defined in the Protocol or the technical explanation. These terms will therefore bear the interpretation they have under U.S. tax law. Gross income for U.S. purposes in manufacturing, merchandising and mining businesses means total sales less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources.

At the 1994 Canadian Tax Foundation Conference,²³ Carol A. Dunahoo, associate international tax counsel for the U.S. Department of the Treasury, opined that payments such as those for the purchase of raw materials for use by the Canadian corporation would be included in cost of sales, and therefore would not be expenses deductible from gross income. The same was said to apply to rental payments for factory premises. The Tax Policy Branch of the Department of Finance was not able to provide any additional guidance as to what the terms gross income and deductible expenses include, other than to state that deductible expenses, in their view, were deductible expenses under Canadian tax law. At this time, discussions by the Tax Policy Branch with the U.S. Treasury Department indicate that the U.S. Treasury has not developed any detailed interpretation of these terms in the context of this or any other U.S. treaty.

The following example illustrates the base erosion test (see figure 1). Canco is a Canadian resident private company, the shares of which are held 51 percent by Canadian resident qualifying persons and 49 percent by a U.K. holding company. Canco distributes specialized waste-water treatment systems under an exclusive distribution agreement and trademark licence from the U.K. shareholder. Canco's territory includes B.C., Alberta, Washington, Oregon and northern California. It has a branch office in Portland, Oregon. It pays 15 percent of its gross profit on each system sold in Canada to the U.K. holding company as commission, and trade mark royalties of \$50,000 annually. In addition, Canco has borrowed \$1 million (Cdn) from the U.K. holding company at 10 percent interest.

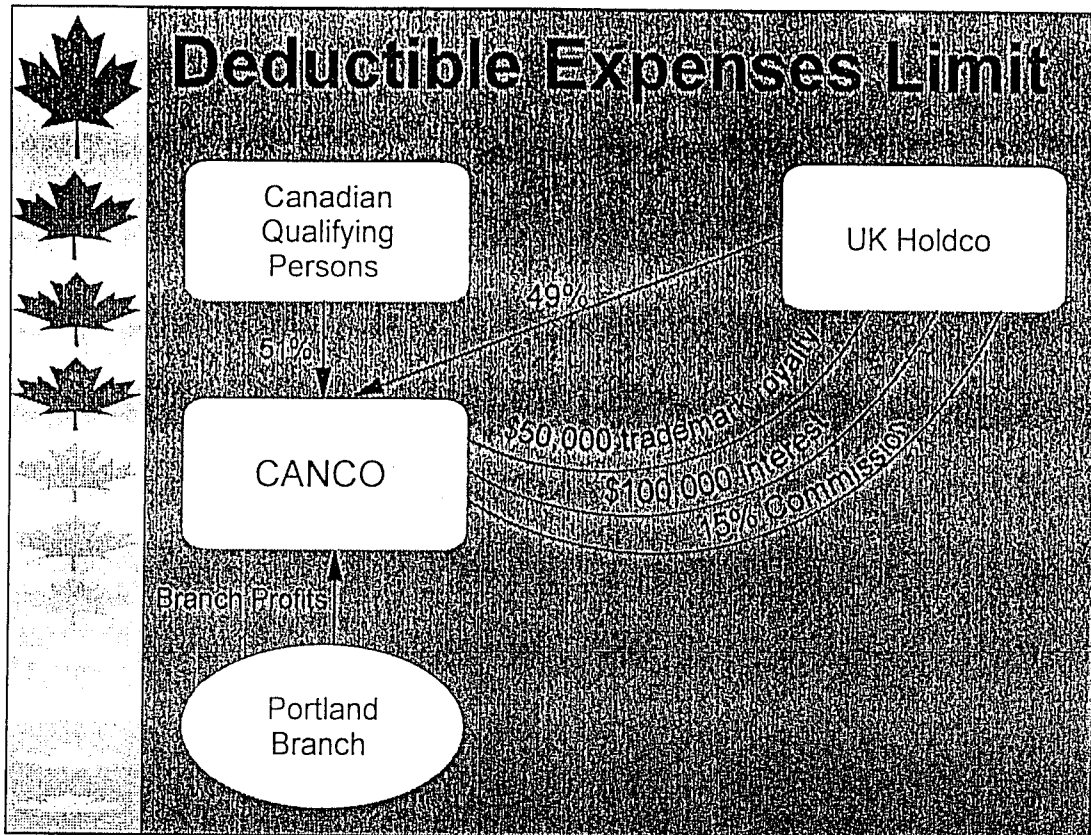


Figure 1

In 1995, Canco has gross income of \$800,000 (Cdn) and pays \$120,000 in commissions, and \$150,000 in interest and royalties to the U.K. shareholder. The total deductible expenses paid to the U.K. shareholder amount to 33.3% of Canco's gross income, so Canco is a qualifying person.

In 1996, Canco's gross income drops to \$400,000. The total commissions, royalties and interest paid to the U.K. is \$210,000, which exceeds 50 percent of gross income. In 1997, Canco will not be a qualifying person (although it will still be entitled to the five percent U.S. withholding tax rate on branch profits and the exemption from U.S. tax for the first \$500,000 of branch profits under the active business rule in paragraph 3 of Article XXIX A, discussed below).

This situation would be aggravated if any of the payments to the U.K. were denominated in a foreign currency, and the Canadian dollar dropped in value against that currency as this would increase the interest cost as a percentage of income. This will be of concern especially where the Canadian company in question is highly leveraged or has a narrow gross margin. It should also be noted that Canadian subsidiaries of foreign banks that are neither qualifying persons nor U.S. citizens or residents are not qualifying persons, so that even if Canco's loan were from a resident Canadian subsidiary of a foreign bank, rather than from a non-resident, the interest deduction would be counted as an expense against gross income. Office rent paid to a Canadian subsidiary of a foreign corporation will also figure in the deductible expense side of the base erosion test.

One effect of Canco ceasing to be a qualifying person is that any subsidiaries of Canco will also cease to be qualifying persons. In a more complex fact situation, this could in turn cause companies which pay significant proportions of their deductible expenses to Canco or its subsidiaries to lose their status as qualifying persons if they also pay large portions of their deductible expenses to third-country residents. It

may be difficult to know, particularly in the case of arm's-length relationships between private companies, whether a payee is a qualifying person in any given fiscal year. Canadian companies that have U.S. source income should review their major expense deductions to ensure they will still be qualifying persons under the new limitation on benefits rules.

Canadian Residents Who Are Not Qualifying Persons: The Active Business Rule

Paragraph 3 of Article XXIX A provides a second avenue for obtaining limited treaty benefits where the Canadian resident is not a qualifying person.²⁴ In essence, certain kinds of U.S. derived income of a Canadian corporation that is not a qualifying person will still be entitled to the reduced withholding tax rates provided the income is connected with or incidental to a substantial Canadian active business.

Paragraph 3 is not an easy provision to interpret or apply. The drafting is ambiguous and is exacerbated by awkward grammar and the use of non-parallel language. The technical explanation is of some assistance in determining the intention of the paragraph, and thus the likely interpretation by the American tax authorities and courts, but does not resolve all ambiguities. As well, the technical explanation diverges in some respects from the actual wording of the paragraph, which may necessitate clarification from the U.S. authorities.

First of all, and this is easily overlooked, the Canadian resident who is not a qualifying person does not have to be carrying on the active trade or business in Canada. It is sufficient if a person related to the Canadian resident is carrying on the active trade or business. The related person need not be a qualifying person, or even a Canadian resident.

U.S. source income that is derived in connection with or which is incidental to the Canadian trade or business will be entitled to treaty benefits. If such income is not derived in connection with or incidental to the Canadian business, it will be taxed at the general withholding rate of 30 percent. For the purposes of the active business rule, a business of making or managing investments does not qualify unless it is carried on by a bank, insurance company, registered securities dealer or deposit-taking financial institution.

On the issue of what constitutes a "substantial" Canadian business, the technical explanation states that the Canadian trade or business need not be as large as the U.S. income generating activity, but it may not represent only a very small percentage of the size of the U.S. activity. Size will be measured in terms of income, assets, or other similar criteria.

The technical explanation gives some guidance, at least as to the intention of the negotiators, with respect to what constitutes income that is derived, directly or indirectly, from the U.S. in connection with an active trade or business engaged in by a Canadian resident in Canada.

If the income-generating activity in the U.S. is "upstream", "downstream" or parallel to that conducted in Canada it will be considered to be connected with the active Canadian business. If the U.S. activity consisted of selling the output of a Canadian manufacturer ("downstream" activity) or providing inputs to the manufacturing process ("upstream activity") or of manufacturing or selling in the U.S. the same sorts of products as are sold by the Canadian business ("parallel activity") the income will be "connected", according to the technical explanation. This will apply whether the U.S. activity is carried on in the U.S. through a branch or a subsidiary or sister corporation of the Canadian resident.

Vertically integrated operations obviously qualify for treaty benefits under the active business rule. The primary difficulty here is in determining what constitutes a parallel activity. If the Canadian business is importing and distributing golf and tennis equipment and the U.S. business involves importing and selling sports equipment generally as well as manufacturing and distributing outdoor furniture, are the

businesses parallel? Is oil production a parallel activity to natural gas production? Is the hotel business parallel to the resort club business? These are the types of questions that will have to be resolved wherever a Canadian resident company may not be a qualifying person because of the base erosion test or because it is not controlled by qualifying person or U.S. persons.

The technical explanation devotes one sentence to the issue of what constitutes income incidental to the active Canadian business. It simply states that income is considered "incidental" to the Canadian trade or business if, for example, it arises from the short-term investment of working capital of the Canadian resident in U.S. securities. The example corresponds to Canadian interpretation of incidental income in the context of the small business deduction, but it does not give a very clear picture of the boundaries of incidental income.

The following are two examples where a combination of factors could result in denial of treaty benefits in a situation where treaty benefits would previously have been available. It is submitted that there is no abuse of the Convention in the fact situations described in these examples.

Suppose Canco (from the earlier example) invests its retained earnings which are not needed as working capital in a variety of Canadian and U.S. investments such as shares of U.S. and Canadian corporations, short- and long-term corporate bonds and Canadian real estate. The investment income is probably not incidental to the active business, since the investments are of a long-term nature. In 1997, when Canco is not a qualifying person, and since Canco is not a bank, insurance company, registered securities dealer or deposit-taking financial institution, the income derived from U.S. securities that are taxable under U.S. law will be subject to the 30 percent withholding rate.

Another common situation in which treaty benefits will be lost is where two brothers, both Canadian residents, set up a Canadian company to invest primarily in Canadian securities and real estate. They own the shares of the company 50-50. A small percentage of the Canadian company's assets, never exceeding 15 percent, is invested in U.S. securities.

Some time later, one brother is transferred by his employer to Chile for a five-year period, and ceases to be a Canadian resident. The investment company ceases to be a qualifying person, since it is no longer controlled by Canadian residents. The U.S. source dividend and interest income is clearly incidental to the main business of the Canadian company of making and managing Canadian investments. However, since the Canadian company is not a bank, insurance company, registered securities dealer or deposit-taking financial institution, its Canadian business does not qualify as the type of active Canadian trade or business of which the U.S.-derived income is entitled to treaty benefits. The U.S. withholding rate on its U.S. source income will be 30 percent under the Protocol, rather than the 15 percent that applied to portfolio dividends and interest prior to January 1, 1996.

Canadian Resident Holding Companies That Are Not Qualifying Persons: The Derivative Benefits Rule

Canadian holding or investment companies that are not controlled by qualifying persons, U.S. persons, or a combination of these, face complex new rules in paragraph 4 of Article XXIX A in order to qualify for the lower withholding rates for dividends, branch profits, interest and royalties sourced in the U.S.

The scheme of paragraph 4 is to accord treaty benefits where a Canadian resident corporation is at least 90 percent controlled, directly or indirectly, by a combination of

- a. qualifying persons
- b. U.S. persons

- c. residents of U.S. tax treaty partners who are entitled to all the benefits of the tax treaty between the U.S. and their country of residence including a withholding tax rate that is no higher than the rate for the same type of income under the Canada-U.S. Convention.

In addition, the base erosion test applies and the active business rule of paragraph 3 may apply.

The underlying rationale of paragraph 4 is that a Canadian corporation which is not a qualifying person because it is not controlled by persons who are Canadians or Americans, should nevertheless be entitled to the low withholding tax rates if the persons who control the corporation would be entitled to the same or lower withholding tax rate under the treaty between the U.S. and their country of residence if they had invested directly in the U.S. In short, if the person would have been entitled to equally advantageous treatment if he had invested in the U.S. directly, he will be entitled to Canadian treaty benefits as a result of having invested in the U.S. through a Canadian corporation.

To qualify for treaty benefits for dividends (including branch profits), interest and royalties, a Canadian resident company which is not a qualifying person must meet the following requirements:

- a. greater than 90% of its shares by votes and value must be owned, directly or indirectly by a combination of qualifying persons, U.S. persons *or other persons*
 - (i) who are residents of third countries that have comprehensive income tax treaties with the U.S. and are entitled to all of the benefits provided by the U.S. under those conventions;
 - (ii) would be qualifying persons if they were residents of Canada or would be entitled to treaty benefits under the active business rule in paragraph 3 if they were Canadian residents and carried on their business in Canada; *and*
 - (iii) are entitled under the tax treaty between their country of residence and the U.S. to a rate of withholding tax in respect of the particular class of income for which benefits are claimed no higher than the rate applicable under the Convention;

and

- b. the amount of deductible expenses paid by the Canadian resident company to persons who are not qualifying persons or U.S. persons during the preceding fiscal period must be less than 50% of gross income (the base erosion test). (Emphasis added).

Examples

The derivative benefits rules can best be understood by analyzing examples utilizing both simple and complicated international structures.

A simple fact situation where the derivative benefits rule will allow treaty benefits is that of a Netherlands private company owned by members of a family of Dutch resident individuals which has a wholly owned Canadian subsidiary, "Canco". Canco owns Canadian real estate and other investments and has a wholly owned U.S. subsidiary, "U.S. Sub" (see figure 2).

The Netherlands has a comprehensive tax treaty with the U.S. If the Netherlands company and its shareholders were residents of Canada, they would be qualifying persons under the U.S.-Canada treaty. The maximum rate of withholding tax for direct dividends under the U.S.-Netherlands treaty is five percent, and the Netherlands company would be entitled to this rate of withholding tax from a directly owned U.S. subsidiary. Therefore, under paragraph 4, Canco will be entitled to the treaty rate of five percent on its dividend income from U.S. Sub.

An area where the derivative benefits rule may be of assistance, but also requires a considerable amount of research and analysis to apply, is that of multinationals

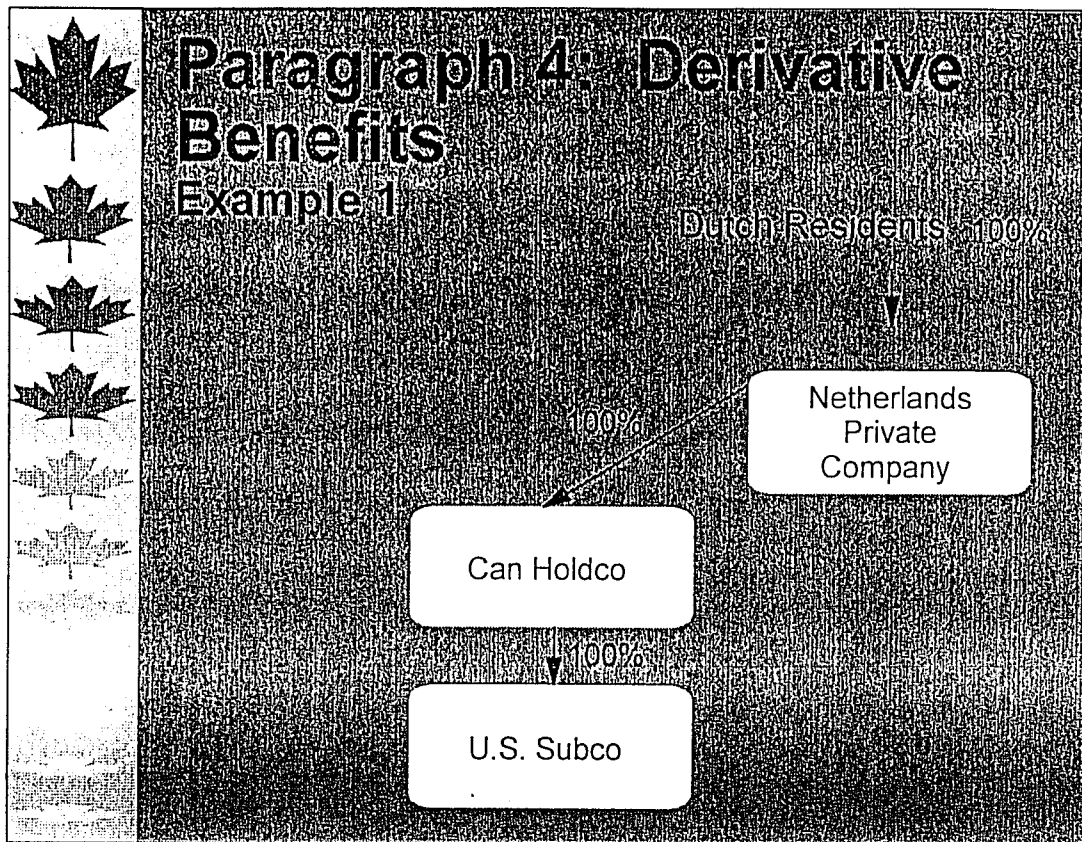


Figure 2

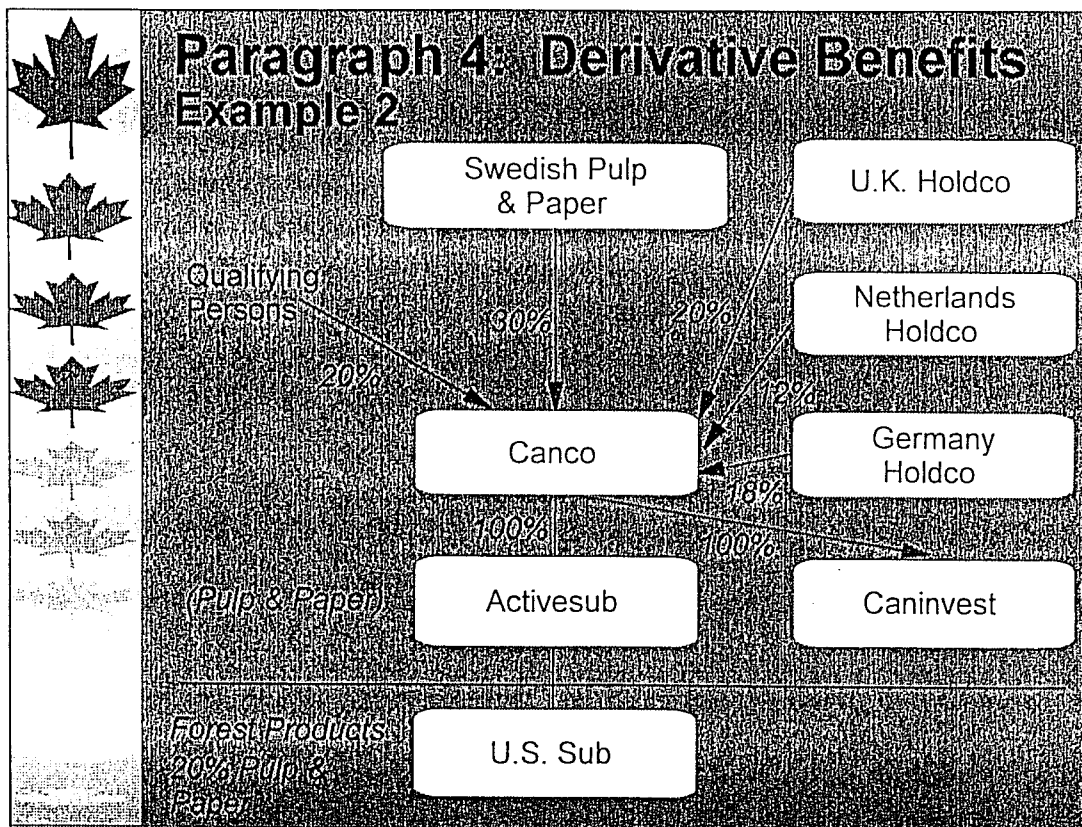


Figure 3

with Canadian and U.S. subsidiaries. Figure 3 illustrates the complexity of the rule and the difficulties that will be encountered in applying it.

Canco is a private corporation resident in Canada. Its shares are held 20 percent by qualifying persons, and 80 percent by corporations resident in the Netherlands, Sweden, Germany and the U.K. Canco has a Canadian subsidiary ("Activesub") that carries on an active pulp and paper products business. Activesub has a U.S. subsidiary ("U.S. Sub") that carries on an active forest products business, one division of which is pulp and paper oriented. Canco has a second Canadian subsidiary, Caninvest, which carries on an investment business, but is not a bank, insurance company, registered securities dealer or deposit-taking institution.

The Swedish shareholder holds 30 percent of the shares in Canco and carries on an active pulp and paper business in Sweden. The U.K., German and Netherlands shareholders are subsidiaries of multinational conglomerates, and each holds between 12 and 20 percent of Canco. The subsidiaries do nothing but hold the Canco shares for their parent companies. The parent companies do not carry on any particular businesses other than holding the shares of numerous subsidiaries carrying on a variety of businesses in numerous different countries.

Caninvest and Activesub are not qualifying persons since Canco is not a qualifying person. The U.S. source income of Caninvest will not be eligible for treaty benefits under paragraph 3 since it is not connected with or incidental to an active business carried on in Canada by Caninvest, Canco or Activesub.

The dividend income of Activesub received from U.S. Sub may also fail to qualify for treaty benefits under paragraph 3, even though Activesub's business is substantial in relation to U.S. Sub's, because their businesses may not be similar enough to be considered parallel. If U.S. Sub's pulp and paper division represents only 20 percent of its overall forest products business, it is not clear that the U.S. authorities would consider that U.S. Sub is manufacturing or selling the same sorts of products that are being manufactured and sold in Canada by Activesub. It might be possible to argue that the proportion of Activesub's dividend income from U.S. Sub that represents the profits of the pulp and paper division of U.S. Sub should benefit from the reduced withholding rates.

To determine if requirement a.(i) is met, the U.S. income tax conventions with Sweden, U.K., Germany and the Netherlands must be reviewed, as well as the shareholdings in Canco of each of the corporations resident in these countries.

The conventions between the U.S. and Germany and between the U.S. and the Netherlands contain anti-treaty shopping provisions that are quite similar to Article XXIX A, but the Canadian tax adviser will have to review them carefully to ensure the corporations in question are qualifying persons under the applicable treaties. The U.K.-U.S. treaty has anti-treaty shopping provisions that are not similar to Article XXIX A. The U.S.-Sweden treaty does not contain anti-treaty shopping rules. For the purposes of this exercise, it is assumed that each of the foreign shareholders is entitled to all treaty benefits under the relevant treaty with the U.S.

The requirement in a.(ii) is that each foreign shareholder would qualify for treaty benefits, if it were resident in Canada and carried on the business that it actually carries on in its home country in Canada, either as a qualifying person as defined in paragraph 2, or under the active business rule in paragraph 3.

To make it easier, it is assumed that all the shareholders would be qualifying persons under the Convention if they were resident in Canada. (However, if the foreign shareholders did not qualify under paragraph 2, it would be necessary for each of them, or a company related to each of them, to carry on a substantial pulp and paper business in the country of residence. In fact, only the Swedish shareholder qualifies under the active business rule of paragraph 3.)

Requirement a.(iii) also necessitates a close review of the tax treaties between the U.S. and the countries of residence of the Canco shareholders, and the percentages each shareholder owns of Canco. This is because the low direct dividend rate requires different levels of shareholdings under different treaties. Each treaty must provide for a five percent or lower direct dividend rate, and each shareholder must have a sufficient shareholding to qualify for that rate.

To be entitled to the low direct dividend rate of five percent under the U.S.-Sweden treaty, the Swedish resident corporation, either alone or with not more than two other corporations, has to have at least 50 percent of the shares. The Netherlands shareholder must have 25 percent of the shares to qualify for the five percent withholding rate under the Netherlands' treaty with the U.S. In this fact situation, therefore, the Swedish and Netherlands shareholders do not qualify under paragraph 4. Since all the requirements of part a. must all be met by the holders of 90 percent or more of Canco's shares, Canco does not qualify for the limited treaty benefits of paragraph 4.

From this example it can be seen that it is extremely important to analyze all the governing factors very carefully. And again, if the Canadian resident corporation is not eligible for treaty benefits because of Article XXIX A, the U.S. withholding tax it pays after the Protocol comes into force will double or triple, rather than decreasing.

This example also demonstrates how the LOB rules can apply where there is no hint of treaty shopping. All of the countries involved are high tax jurisdictions with comprehensive tax treaties with the U.S. The failure to qualify for treaty benefits results from different requirements in the various U.S. treaties, and specifically because the Canadian direct dividend definition is less strict than that in most of the other U.S. treaties. From the Canadian viewpoint the allocation of jurisdiction to tax on the basis of residence is effectively reversed, and tax revenue which would have flowed to the Canadian fisc is diverted in large part to the American treasury as a result of the Canadian foreign tax credit.

Paragraph 6: The Last Resort

Paragraph 6 allows a person resident in Canada which is not entitled to treaty benefits under paragraph 2, 3 or 4 to request the competent authority of the U.S. to determine, on the basis of all the factors including the history, structure, ownership and operations of that person, whether

- (a) its creation and existence did not have as a principal purpose the obtaining of benefits under the Convention that would not otherwise be available; or
- (b) it would not be appropriate, having regard to the purpose of this Article, to deny the benefits of the Convention to that person.

The person shall be granted the benefits of the Convention by the United States where the competent authority determines that subparagraph (a) or (b) applies.

This provision may well provide an avenue of relief for Canco and its subsidiaries in the preceding example. If Canco had been operating under the same or a similar structure for some time on January 1, 1996, and the structure reflects commercial objectives of the group, it would presumably be clear that a principal purpose for the creation and existence of Canco and its subsidiaries was not the obtaining of treaty benefits. It has a legitimate, active business in Canada, it has U.S. income derived in the same sector of the economy, its ultimate shareholders are taxpayers resident in countries with which the U.S. has treaties and which have tax rates which are comparable to or higher than in the U.S.

However, the request to the U.S. competent authority for relief is not the method of choice for obtaining treaty benefits. It is neither quick nor inexpensive, and the subjectivity of the test renders the outcome uncertain. The technical explanation states that a taxpayer will be expected to present its case to the competent author-

ity for an advance determination based on the facts, and that if relief is granted it will be retroactive to the time the relevant treaty provision entered into force or the structure was established, whichever is later.

Paragraph 7: The Notwithstanding Clause

Paragraph 7 of Article XXIX A provides that the provisions of Article XXIX A shall not be construed as restricting in any manner the right of Canada or the U.S. to deny benefits under the Convention where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Convention.

This is the provision which allows Canada (and the U.S.) to deny treaty benefits to U.S. residents where it considers that abusive treaty shopping would otherwise result. Although the circumstances where treaty benefits will be denied to U.S. residents by Canada is not the focus of this article, the recent judgment of the Supreme Court of Canada in *The Queen v. Crown Forest Industries Ltd.*²⁵ contained a clear condemnation of treaty shopping as contrary to the intentions of Canada and the U.S. in entering into the residence provisions of the Convention.

Tax Effects of Denial of Treaty Benefits

In most cases, the denial of treaty benefits will not result in an actual increase in the combined tax burden, due to the foreign tax credit (or optional deduction) allowed by Canada. Since the usual rate of tax for corporations in Canada on foreign source income exceeds 30 percent, a full credit against Canadian tax otherwise payable will usually be available for tax paid to the U.S. A discussion of the technicalities of the foreign tax credit mechanism is beyond the scope of this article, but the following are examples of the types of problems that could arise.

One situation is where a non-qualifying Canadian corporation has a branch operation in the U.S. and either the Canadian business is considered not to be substantial in relation to the U.S. business, or the income derived in the U.S. is not connected with or incidental to the Canadian business. The U.S. branch will pay U.S. income tax at approximately 40 percent and U.S. withholding tax on branch profits will be charged at 30 percent on the remainder for a total of approximately 58 percent. The Canadian resident will be entitled to a foreign tax credit only to the extent of the Canadian tax otherwise payable on the income, approximately 45 percent. The corporation's overall tax burden in respect of its U.S. income will have increased by 13 percent by reason of the LOB rules.

Another example of an increase in the combined tax burden is where the active business rule does not apply because the income of the Canadian and U.S. businesses of a Canadian corporation that is not a qualifying person and its U.S. subsidiary are not considered to be connected. Dividends paid by the U.S. subsidiary paid out of active business earnings will not be taxable in Canada, but are also not eligible for a foreign tax credit. The U.S. subsidiary will pay approximately 40 percent U.S. tax as a resident of the U.S., and the Canadian parent will pay 30 percent withholding tax on the dividend, instead of the Protocol rate of five percent. Thus the total tax burden of parent and subsidiary on the income of the U.S. subsidiary will be 70 percent rather than 45 percent if treaty benefits were available.

Cash flow difficulties will be exacerbated in a situation where treaty benefits are denied to a Canadian parent on dividends received from a subsidiary and the Canadian parent is in a loss position. Since the Canadian parent will have no Canadian tax otherwise payable it will not be able to use the foreign tax credit. However, an optional provision will apply by which the Canadian parent can elect to increase its income to the amount necessary to use the credit, and then add the same amount to its non-capital losses available for carry forward to subsequent profitable years. While eventually the U.S. tax paid will be offset by deducting the additional losses

against future profits to reduce Canadian tax, the tax withheld in the loss year will be a cash outlay in a year when the corporation may be short of funds. In addition, the election to increase federal income to utilize the credit may result in additional provincial corporate tax.

SUMMARY

The LOB rules reach well beyond what can reasonably be perceived as treaty shopping. In effect, the rules substantially amend the definition of resident in the Convention as it applies to Canadian corporations. Whether or not the application of the LOB rules results in an increased tax burden for cross-border businesses, they will require Canadian corporations who have, or intend to have, U.S. source income to take into account the extremely complex rules whenever changes to the U.S. or Canadian business or corporate structure or the ownership of the Canadian corporation are contemplated. From a Canadian tax policy standpoint, the effect of the LOB rules could result in a substantial re-direction of tax revenues from Canada to the U.S.

ENDNOTES

1. Convention Between Canada and the United States of America with Respect to Taxes on Income and Capital, signed at Washington, DC on September 26, 1980 as amended by the protocols signed on June 14, 1983 and March 28, 1984, *Canada-United States Tax Convention Act*, 1984, S.C. 1984, c. 20, Schedule I.
2. Bill S-9, An Act to amend the Canada-U.S. Tax Convention Act, 1984
3. *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) subsections 250(4) and (5.1).
4. *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) as amended; section 212.
5. Internal Revenue Code ss. 881,871
6. Convention Article X(2); Protocol Article 5(1).
7. Convention Article X(6); Protocol Article 5(1).
8. Convention Article XI(2); Protocol Article 6(1).
9. Convention Article XII(3); Protocol Article 7(1).
10. Convention Article XI(3)(d); Protocol Article 6(2).
11. Convention Article XXIX A; Protocol Article 18.
12. A direct dividend is one received by a corporate taxpayer that owns at least 10 percent of the voting stock of the company paying the dividends: Article X(2)(a) of the Convention as amended by Protocol Article 5(1). Any other dividend is a portfolio dividend. Dividends paid by U.S. real estate investments trusts (REITs), registered investment corporations (RICs) and Canadian non-resident owned investment corporations (NROs) are governed by special rules.
13. While there is no reduction in the withholding tax rate on royalties, the categories of royalties that are exempt from withholding tax altogether are expanded, notably to include payments for computer software, patented information and information concerning industrial, commercial or scientific experience (except such information provided in connection with a rental or franchise agreement). Copyright royalties except in respect of motion pictures and videos were already exempt under the Convention.
14. Treasury Department Technical Explanation of the Protocol Amending the Convention between the United States of America and Canada with respect to Taxes on Income and on Capital, released June 13, 1995.
15. The Supreme Court of Canada has recently condemned treaty shopping as an abuse in *The Queen v. Crown Forest Industries Limited* 95 DTC 5389.
16. Article III(2) of the Convention provides that, as regards the application of the convention by a Contracting State, any term not defined therein shall, unless the context otherwise requires and subject to the provisions of Article XXVI (Mutual Agreement Procedure), have the meaning that it has under the law of that State concerning the taxes to which the Convention applies.
17. Convention between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income.
18. For a useful comparison of the definitions provided in the U.S.-Netherlands treaty, and an excellent discussion of the limitation on benefits rules generally, see Janice G. Russell, "The New Limitation-on-Benefits Article", *Canadian Tax Journal* (1995), Vol. 43, No. 4, 964-982.
19. Paragraph 2 of Article XXIX A provides:
 2. For the purposes of this Article, a qualifying person is a resident of Canada that is:

- (a) a natural person;
 - (b) the Government of Canada or a political subdivision or local authority thereof, or any agency or instrumentality of any such government, subdivision or authority;
 - (c) a company or trust in whose principal class of shares or units there is substantial and regular trading on a recognized stock exchange;
 - (d) a company more than 50 percent of the votes and value of the shares (other than debt substitute shares) of which is owned, directly or indirectly, by five or fewer persons each of which is a company or trust referred to in subparagraph (c) provided that each company or trust in the chain of ownership is a qualifying person or a resident or citizen of the United States;
 - (e) (i) a company 50 percent or more of the votes and value of the shares (other than debt substitute shares) of which is not owned, directly or indirectly, by persons other than qualifying persons or residents or citizens of the United States, or
 - (ii) a trust 50 percent or more of the beneficial interest in which is not owned, directly or indirectly, by person other than qualifying persons or residents or citizens of the United States,
 where the amount of the expenses deductible from the gross income that are paid or payable by the company or trust, as the case may be, for its preceding fiscal period (or, in the case of its first fiscal period, that period) to persons that are not qualifying persons or residents or citizens of the United States is less than 50% of its gross income for that period;
 - (f) an estate;
 - (g) a not-for-profit organization, provided that more than half of the beneficiaries, members or participants of the organization are qualifying persons or residents or citizens of the United States; or
 - (h) an organization described in paragraph 2 of Article XXI (Exempt Organizations) and established for the purpose of providing benefits primarily to individuals who are qualifying persons, persons who were qualifying persons within the five preceding years, or residents or citizens of the United States (such as pension funds).
20. These include the major national American exchanges.
 21. The list of recognized stock exchanges may be enlarged by agreement between Canada and the U.S. by exchange of notes or by their competent authorities: Convention Article XXIX A(5)(a)(iii).
 22. *Supra*, endnote 2, subsections 125(7) and 248(1).
 23. "Summary of International Tax Planning 1: Canada-U.S. Cross-Border Issues" in *Report of Proceedings of the Forty-Sixth Tax Conference*, 1994 Conference Report (Toronto: Canadian Tax Foundation, 1995), 24: 1-50 at 13-14.
 24. 3. Where a non-qualifying Canadian resident, or a person related thereto, is engaged in the active conduct of a trade or business in Canada (other than the business of making or managing investments, unless those 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), the benefits of the Convention shall apply to that resident person with respect to income derived from the U.S. in connection with or incidental to that trade or business, including any such income derived directly or indirectly by that Canadian resident person through one or more other persons that are residents of the U.S. Income shall be deemed to be derived from the United States in connection with the active conduct of a trade or business in Canada only if that trade or business is substantial in relation to the activity carried on in the U.S. giving rise to the income in respect of which benefits provided under the Convention by the United States are claimed.
 25. *Supra*, endnote 13.