CANADA-US TAX TREATY UPDATE
LIMITATION ON BENEFITS

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Canada's first limitation on benefits provision requires Canadian advisors to test all inbound Canada/US structures to ensure desired tax results

The structuring of inbound investment into Canada has always been concerned with the tax effect of the proposed structure. Cross-border structuring is fraught with tax issues, and the number of issues has only increased with the introduction of the Fifth Protocol to the Canada-US Tax Treaty (the Treaty) in 2008. As many readers are aware, the Fifth Protocol contained anti-hybrid rules that have adversely affected the use of Canadian unlimited liability corporations (ULCs) in cross-border structures. Some of the ULC issues have been solved by administrative concession by the Canada Revenue Agency, while some of the problems remain.

In addition to the anti-hybrid rules, the Fifth Protocol introduced Canada's first limitation on benefits (LOB) provision in Article XXIX-A of the Treaty. In general, the Treaty provides relief from double taxation to qualifying Canadian and United States residents. The Treaty is intended to apply to bona fide tax residents of both countries. Both Canada and the United States have sought to prevent perceived abuses of the Treaty by persons who would not otherwise be resident in either country but for their desire to take advantage of the Treaty's benefits. This is known as "treaty shopping."

Traditionally, Canada and the United States have taken different approaches to treaty shopping. Canada has historically preferred to apply domestic anti-avoidance legislation, including the general anti-avoidance rule (GAAR) found in the *Income Tax Act* (ITA), rather than including specific provisions in treaties to prevent perceived abuses. In contrast, the United States prefers to include a "limitation on benefits" (LOB) article within the treaties themselves that specifically outlines who is and is not eligible for treaty benefits.

From 1995 until 2008, this difference of approach was reflected in an asymmetric LOB article in the Treaty, whereby a United States resident seeking relief from Canadian tax merely had to establish residency under the Treaty and that the US resident was the beneficial owner of the income. On the other hand, a Canadian resident seeking relief from United States tax had to comply with the LOB article in the Treaty.

In 2008, with the introduction of the Fifth Protocol to the Treaty, the LOB article was rendered symmetric for taxation years that begin after 2008. Therefore, as of 2009, Canadian advisors must test the inbound structure in order to ensure that it meets the LOB provisions in the Treaty. The LOB article (or slight variations thereof) is a common feature in United States treaties and forms a part of the United States Model Income Tax Convention (dated November 15, 2006, available at http://www.irs.gov/pub/irs-trty/model006.pdf). On the Canadian side, there is limited guidance in application of the LOB provisions, although there is a growing body of CRA interpretations, some of which are discussed below.

Application

Qualifying Persons

The LOB article states that a "qualifying person" is entitled to all the benefits of the Treaty. Persons who are not qualifying persons may be entitled to specific benefits (or benefits in specific circumstances) as explicitly set out in the article, but are otherwise denied Treaty benefits.

"Qualifying person" is defined to include a variety of residents of an applicable country, including:

- natural persons;
- publicly traded companies or trusts;
- certain companies owned and controlled by publicly traded companies or trusts;
- companies that meet certain ownership and "base erosion" tests;
- other assorted entities (estates, not-for-profits, etc.).

Certain qualifying persons are straightforward. However, the "base erosion" test requires some explanation.

The ownership/base erosion test for a corporation is as follows (a similar test applies to interests in trusts):

i. 50 per cent or more of the aggregate vote and value of the company's shares and 50 per cent or more of the vote and value of each "disproportionate class of shares" must *not* be owned by persons other than qualifying persons (Ownership Test); and
ii. the amount of the expenses deductible from gross income (as determined pursuant to the laws of the relevant company's country of residence) that are paid or payable for the company's preceding fiscal period directly or indirectly to persons that are not qualifying persons must be less than 50 per cent of the company's gross income for that period (Base Erosion Test).

"Disproportionate class of shares" refers to any class of shares entitling a shareholder of a company resident in one country to disproportionately higher participation, through dividends, redemptions or otherwise, in the earnings generated in the other country by particular assets or activities of the company.

With respect to the ownership test, the technical explanation clarifies that where shares are owned by qualifying persons that are publicly traded companies or trusts, it will not be necessary to "look through" the publicly traded company or trust to determine its ownership structure. However, where shares are held by other companies resident in the same treaty country, the ownership structure of those companies must generally be similarly examined in order to determine indirect ownership of the shares of the company subject to the ownership test.

The base erosion test looks to the payment of deductible expenses to prevent taxable income of an otherwise-qualifying resident from being siphoned off by ostensible service providers who are not themselves qualifying entities.

CRA recently addressed the issue of what would constitute payments made "indirectly" to non-qualifying persons. CRA clarified that it will interpret payments made "indirectly" in a manner similar to how it has interpreted those words in the context of a similar provision in the ITA. Effectively, payments will be considered to be made indirectly to a non-qualifying person where "there is a sufficient link between the payment [to a qualifying person] and a subsequent payment by the qualifying person to a non-qualifying person." In turn, a "sufficient link" will depend on an analysis of all relevant facts and circumstances, including whether a payment to a qualifying person "was conditional on the amount being paid or payable to a non-qualifying person" (CRA document 2009-0317941E5, dated April 12, 2010).

Active Trade or Business

Even where a resident of a Treaty country is not a qualifying person under the LOB article, it may still take advantage of certain benefits in certain circumstances. A resident of a country that is "engaged in the active conduct of a trade or business" in that country is eligible for all Treaty benefits with respect to income derived in the other country "in connection with or incidental to that trade or business," provided the trade or business is "substantial" in relation to the activity carried on in the other country that gives rise to the income.

CRA interpretations released since the LOB article became applicable to those seeking Canadian Treaty benefits have provided some clarification as to the meanings of "active trade or business" and "substantial" activity.

Income earned "in connection with" an "active trade or business" is described both in the technical explanation and by CRA as Canadian-sourced income derived from an activity in Canada that is a part of, or is complementary to, a trade or business in the United States. An activity in Canada will be part of a trade or business in the United States where the trade or business is "upstream, downstream or parallel" to the activity in Canada, meaning they "relate to the production of the same types of products or the provision of the same or similar services." Activities are complementary where they are interdependent activities forming part of the same industry (CRA document 2009-0336401C6, dated September 16, 2009).

CRA has clarified that "substantial" activity is not governed by a "safe harbour" style test that is explicitly contained in some United States treaties. Under such a test, activity would be deemed substantial where each of the asset value, gross income and payroll expense related to the trade or business in the residence state equals at least a certain percentage (e.g., 7.5 per cent) of each of the asset value, gross income and payroll expense, respectively, related to the activity that generated the income in the other state. The average of the three ratios would also have to equal a certain percentage (e.g., 10 per cent).

CRA rejected the application of such a test to the "substantial activity" requirement, stating that the technical explanation to the LOB article forms the basis for applying the substantial activity test. The technical explanation does not provide precise ratios, stating only that the active trade or business must be more than "a very small percentage" as compared to the activity in the other country. All of the facts and circumstances must be considered, with a view to preventing treaty shopping (CRA document 2009-0345881C6, dated November 2, 2009).

Derivative Benefits

Benefits under the Treaty relating to dividends (Article X), interest (Article XI) and royalties (Article XII) are available under a "derivative benefits" provision that explicitly allows these benefits to companies that are resident in Canada or the United States whose shares meet the following test: more than 90 per cent of the aggregate vote and value of all of the company's shares, and at least 50 per cent of the vote and value of any disproportionate class of shares, must be owned directly or indirectly by qualifying persons *or*, generally, residents of other countries who have tax treaties with the other Treaty country and would be entitled to similar benefits if they were resident in the first Treaty country (note that there are several other stipulations). A base erosion test similar to the one above is also applied to determine eligibility under this heading.

To the extent that a US resident is not able to qualify for treaty benefits under any of the tests described above, there is the possibility of referring the issue to a competent authority for review.

Conclusion

While the LOB analysis has been commonplace for US advisors for more than 15 years, it is relatively new for Canadian advisors. All inbound Canada/US structures need to be reviewed in order to ensure that the desired tax results are not denied by the LOB provisions. While some guidance has been provided, uncertainties remain with respect to the Article's application in particular circumstances.

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