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08/12/09

Conducting Business with Hybrid Tax Entities Between the United States and Canada: The Impact of New Paragraph 7 to Article IV of the U.S.-Canada Income Tax Treaty

The Fifth Protocol (the "Protocol") to the U.S.-Canada Income Tax Treaty ("Treaty") entered into force on December 15, 2008. The Protocol is generally effective for tax years beginning on or after January 1, 2009; however, certain provisions of the Protocol have a delayed effective date, including Paragraph 7 of Article IV, which is effective beginning January 1, 2010.

The Protocol makes significant changes to the tax treatment of hybrid tax entities used to conduct cross-border activities. These changes to the Treaty necessitate a review and reassessment of cross-border structures used by U.S. persons to conduct business or make investments in Canada. Please see *"Investing in Canada Through a U.S. Limited Liability Company: The Impact of New Paragraph 6 to Article IV of the Canada-U.S. Tax Treaty"* (http://www.lanepowell.com/wp-content/uploads/2009/07/tax_law.pdf), dated July 14, 2009, regarding the impact of the Protocol with respect to new Paragraph 6 of Article IV of the Treaty on the treatment of income derived through or paid by fiscally transparent entities, such as limited liability companies and partnerships.

Impact of Paragraph 7, Article IV of the Treaty on Hybrid Tax Entities

New Paragraph 7, Article IV of the Treaty establishes new criteria to secure treaty benefits on amounts derived through or paid from hybrid tax entities (an entity having inconsistent characteristics for Canadian and U.S. tax purposes). Paragraph 7 is an "anti-hybrid" rule that either grants or denies treaty benefits to persons having an interest in a hybrid entity. These rules are separated into two subparagraphs as follows:

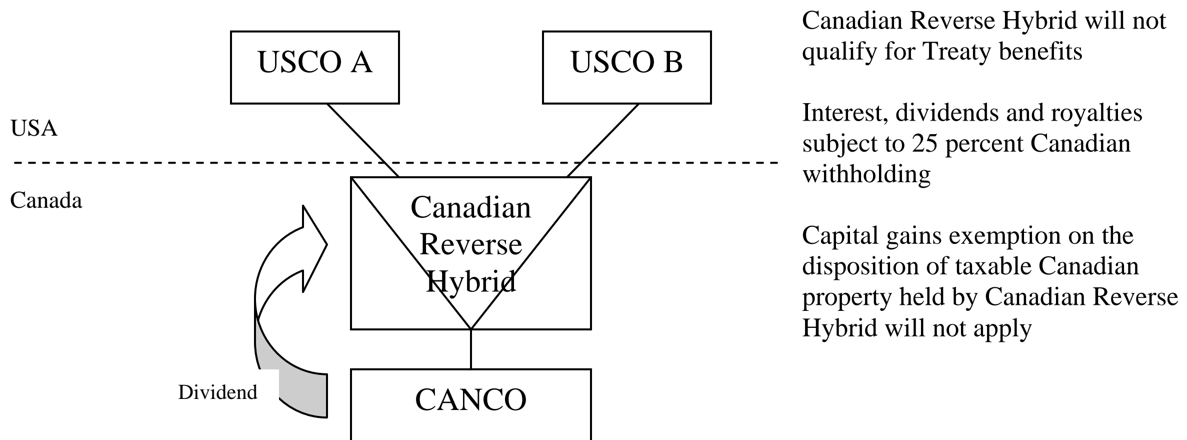
Paragraph 7(a), Article IV

Paragraph 7(a) applies to situations where an entity receiving income is treated as a taxable corporation in one country but as a fiscally transparent entity in the other country, resulting in inconsistent tax treatment of the entity between the Treaty countries. For example, an Alberta unlimited liability company ("ULC") is treated as a taxable corporation in Canada but can be a fiscally transparent entity for U.S. tax purposes. Where the tax classification of an entity by Canada and the United States is inconsistent, new Paragraph 7(a) may apply to deny reduced Treaty rates on income received by that entity. Paragraph 7(a) works as follows: income, profit or gain will not be considered to be paid to or derived by a person who is a resident of a Contracting State (the "Residence Country") where the person is considered under the taxation law of the other Contracting State (the "Source Country") to have derived the amount through an entity that is not a resident of the Residence Country, but by reason of the entity not being treated

as fiscally transparent under the laws of the Residence Country, the treatment of the amount under the taxation law of the Residence Country is not the same as its treatment would be if that amount had been derived directly by that person.

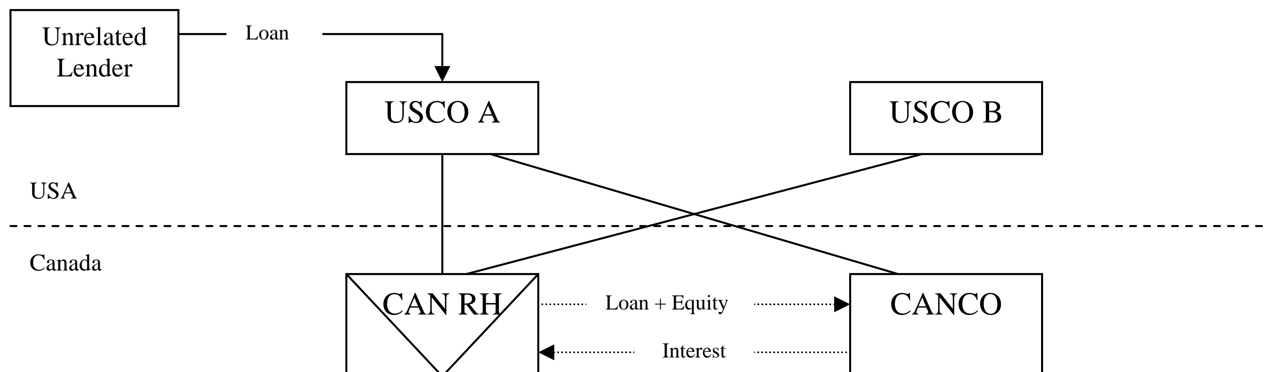
Three conditions must be met for Paragraph 7(a) to apply (using the United States as the Residence Country). If the following conditions exist, the result is the loss of a lower withholding tax under the Treaty: (1) a resident of the United States is considered to have derived an amount "through an entity" for Canadian tax purposes; (2) the entity is not a resident of the United States; and (3) the treatment of the amount for U.S. tax purposes is different than it would have been had the amount been derived directly by the resident of the United States because the entity is not fiscally transparent for U.S. purposes.

The loss of Treaty benefits under Paragraph 7(a) is illustrated by the following example involving two U.S. parties that decide to invest into Canada through Canadian Reverse Hybrid. Canadian Reverse Hybrid is established as a partnership or other pass-through entity under Canadian law and treated as such for Canadian tax purposes. For U.S. tax purposes, however, Canadian Reverse Hybrid has "checked the box" to be treated as a corporation. USCO A and USCO B are treated as deriving the dividends paid by CANCO through an entity for Canadian tax purposes. The entity is not a resident of the United States and USCO A and USCO B will not be treated as receiving the income directly because Canadian Reverse Hybrid is a corporation for U.S. purposes. Consequently, Treaty benefits will not apply to the dividend paid by CANCO and CANCO will be required to withhold and submit 25 percent of the dividend payment to Canada Revenue Agency.



This rule appears to apply in Canada to so-called "synthetic NRO" financing structures that essentially use a "reverse hybrid" partnership with U.S. corporate partners to finance Canadian group operations. As an example, two U.S. companies, USCO A and USCO B, establish and capitalize a Canadian partnership (CAN RH), which "checks the box" to be treated as a corporation for U.S. tax purposes. Canada would "look-through" the Canadian partnership and view the interest income received by CAN RH as being paid directly to USCO A and USCO B. However, the United States would view the interest being paid to CAN RH, a Canadian corporation, by reason of the "check-the-box" election. Thus, Paragraph 7(a) will deny Treaty

benefits to the interest payment by CANCO and withholding at the Canadian withholding rate would be required.



Paragraph 7(a) will also play a role in the Canadian taxation of S corporations. S corporations are treated as a fiscally transparent entity for U.S. tax purposes; however, as a result of Paragraph 7(a), S corporations are somewhat of a special case. Although under Paragraph 6, where an S corporation is owned by U.S. residents, the U.S. residents will be considered for purposes of the Treaty as the person that derives the income, Canada accepts the S corporation as a "resident" as defined in Article IV of the Treaty and therefore allows it to benefit from the Treaty in its own right. On the other hand, if the S corporation is owned by a U.S. citizen who is a Canadian resident, treaty benefits will not apply to the U.S. source income, profits or gain as the Canadian resident will not be considered as deriving the income by virtue of Paragraph 7(a), since Canada does not treat the S corporation as fiscally transparent.

Paragraph 7(b), Article IV

In the past, U.S. investors have used Canadian ULCs as vehicles to invest in Canada. A ULC is treated as a corporation for Canadian tax purposes and under the check-the-box regulations, may be treated as a flow-through entity for U.S. tax purposes.

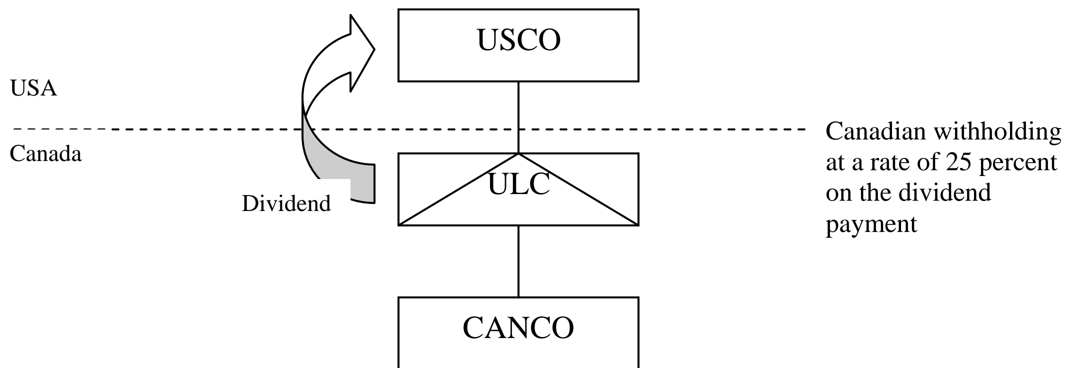
Paragraph 7(b) provides that an amount of income, profit or gain will be considered to be paid to or derived by a person who is not a Treaty resident where that person is considered under the taxation law of the Source Country to have received the amount from an entity that is a resident of the Source Country (*i.e.,* a non-fiscally transparent entity), but by reason of the entity being treated as fiscally transparent under the laws of the Residence Country, the treatment of the amount under the taxation law of the Residence Country is not the same as its treatment would be if that entity were not treated as fiscally transparent under the laws of the Residence Country.

Under new Paragraph 7(b), a Canadian ULC will not be treated as a resident under the Treaty if the ULC is treated as a flow-through entity for U.S. tax purposes. Thus, dividends, interest or royalty payments paid by a Canadian ULC to its U.S. investors will be subject to Canada's 25 percent withholding tax rate rather than the lower Treaty rates (0 to 15 percent) applicable to such income. Paragraph 7(b) also appears to deny Treaty benefits, for example, to interest payments made by a ULC to its U.S. corporate parent on "disregarded debt" for U.S. federal income tax purposes.

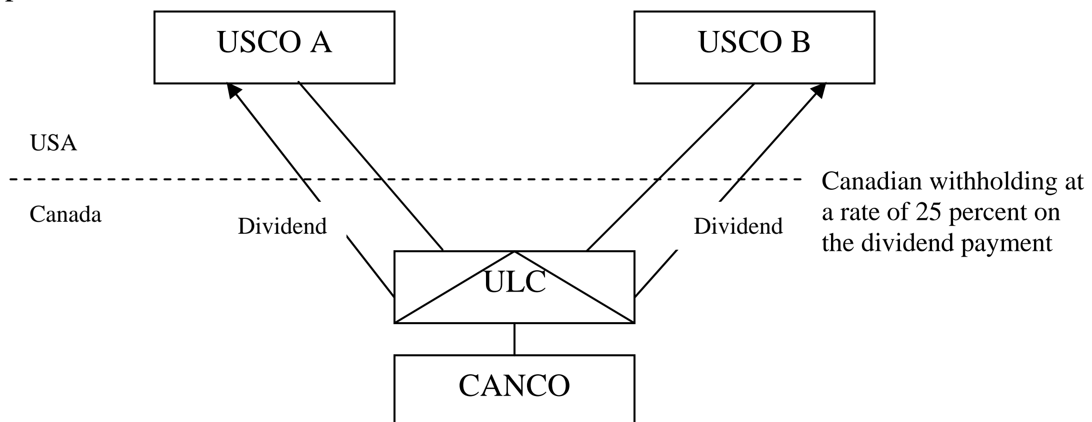
The Technical Explanation of the Protocol (the "TE") prepared by the United States Department of Treasury and subscribed to by the Government of Canada provides three examples illustrating the application of Paragraph 7(b):

(1) Treaty protection from Canadian tax would be denied with respect to a dividend, interest or royalty payment received by a U.S. company from its wholly-owned Canadian subsidiary that is considered a corporate resident under Canadian tax law and a disregarded entity under U.S. tax law.

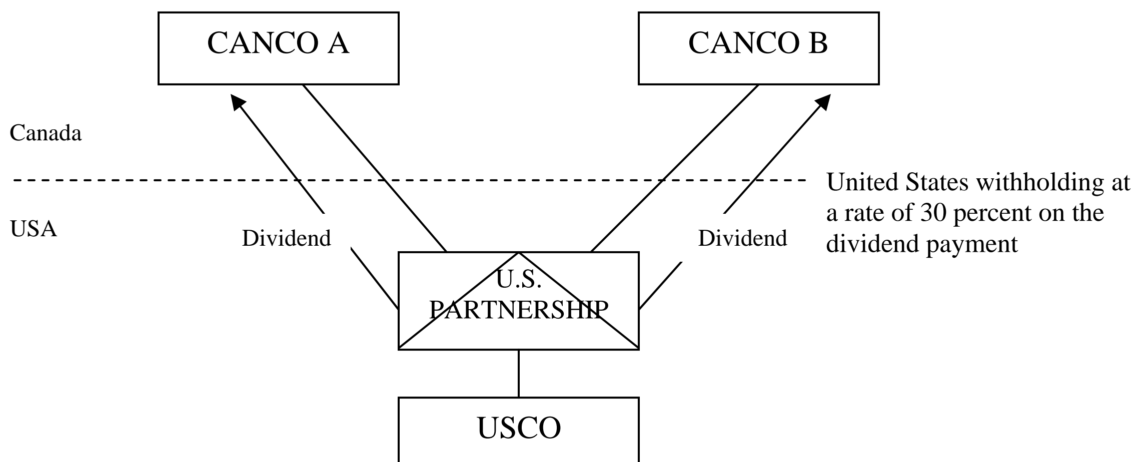
In the following example, USCO invests in a Canadian ULC that is treated as a corporation for Canadian tax purposes, but that is treated as a disregarded entity under the U.S entity classification rules. When ULC distributes a dividend for Canadian tax purposes to USCO, because ULC is treated as a disregarded entity for U.S. purposes, the distribution will be treated differently than if ULC were a corporation under U.S. tax laws. Accordingly, Paragraph 7(b) denies Treaty benefits to the distribution and ULC will be required to withhold Canadian tax on the distribution. The same denial of Treaty benefits will occur if USCO receives income treated as a royalty or interest under Canadian tax law.



(2) Reduced rates of Canadian tax under the Treaty will also be denied with respect to a dividend received by a U.S. company from a Canadian entity that is considered a corporate resident under Canadian tax law and a partnership (rather than disregarded entity) under U.S. tax law. The payment would be treated as a taxable dividend for Canadian tax purposes, but as a non-taxable partnership distribution for U.S. tax purposes.



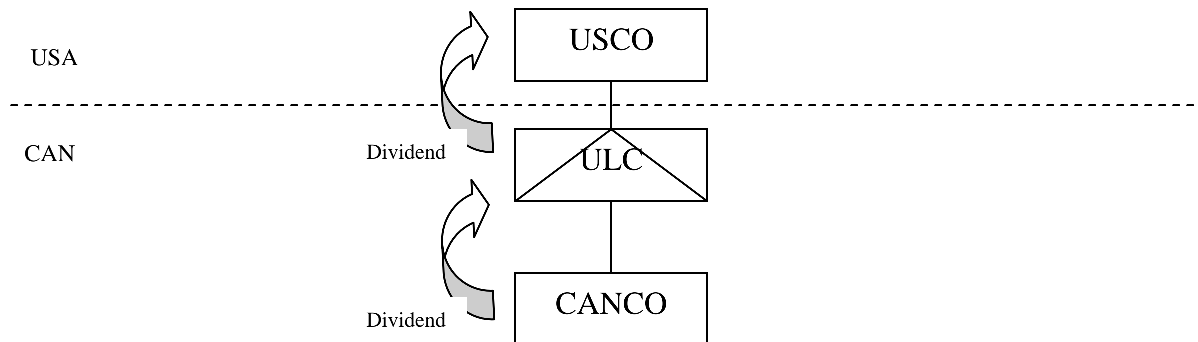
(3) Treaty protection from U.S. tax would be denied with respect to a dividend, interest or royalty payment received by a Canadian company from a U.S. entity that is considered a branch under Canadian tax law and a corporation under U.S. tax law. Again, the tax treatment of the payment from U.S. Partnership to CANCO A and CANCO B is different for U.S. tax purposes and Canadian tax purposes; accordingly, Paragraph 7(b) will limit Treaty benefits and U.S. Partnership would be required to withhold 30 percent on the payments to CANCO A and CANCO B.



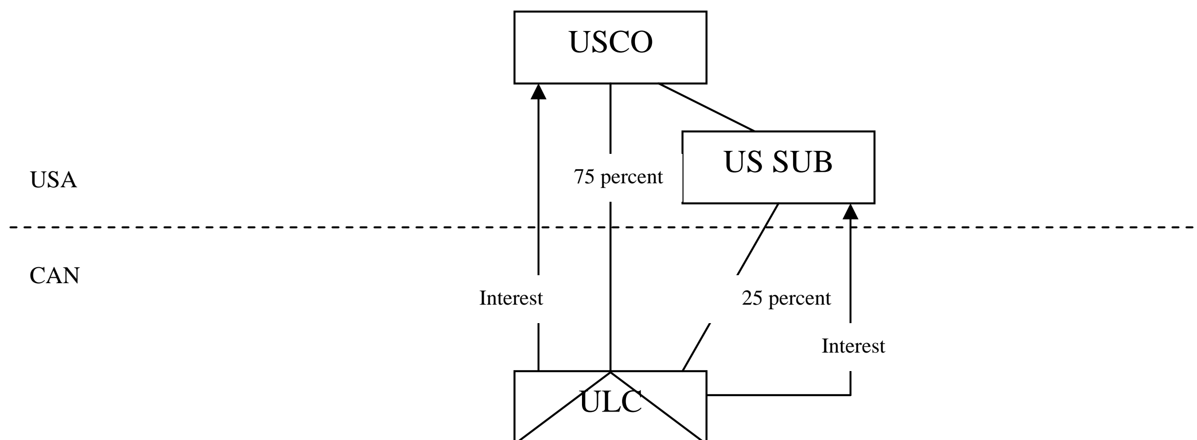
As illustrated from the examples above, the central question for Treaty benefits under new Paragraph 7 is the sameness of the tax treatment of the income in Canada and the U.S. The TE provides some guidance, stating that the principles of Treasury Regulation section 1.894-1(d)(3)(iii) will apply in order to make a determination of "same treatment." Pursuant to Treasury Regulation section 1.894-1(d)(3)(iii), the consistency in the treatment of the character, source and timing of income under the resident country's tax laws will be "same treatment." Although this general statement is included in the TE, the TE does not provide an example relating to deductible interest or royalty payments from a hybrid partnership entity to one of its owners. The TE states that, while "[o]ne might expect that subparagraph 7(b) would not apply in this case because the fiscal transparency of the partnership would generally not be relevant for residence-country tax purposes," the lack of an explicit discussion or example on this point causes "uncertainty regarding deductible payments made by a domestic reverse hybrid ("DRH") partnership entity to one of its Canadian [or U.S.] owners."

The Canada Revenue Agency ("CRA") and Canada's Department of Finance have consistently stated that they will also look to the quantum, timing, character and source as factors they will consider in determining whether income has the "same treatment." The CRA has recently offered some examples of the application of Paragraph 7(b). CRA's comments appear to deny Treaty benefits to "back-to-back arrangements" where the ULC is a disregarded entity for U.S. tax purposes. Previously, some commentators have suggested that arrangements would be entitled to Treaty benefits as the dividend income included in USCO's U.S. income would be the same for U.S. and Canadian tax purposes.

The "back-to-back arrangement" situation arises where ULC, immediately after receipt of a dividend from CANCO, pays a dividend of identical amount to USCO.



Although the amount included in USCO's income is the same for U.S. and Canadian tax purposes under the example above, the CRA's position appears to be that Paragraph 7(b) would in fact apply to deny Treaty benefits in the situation above. However, according to CRA, Paragraph 7(b) may not apply in certain situations where ULC is treated as a partnership for U.S. purposes rather than as a disregarded entity. For example, consider a situation where two U.S. shareholders own the ULC, and USCO and US SUB make a loan to ULC and receive interest income from ULC in respect of that loan:



In this situation, USCO and US SUB would each include the interest as income (which would not be the case if ULC was a disregarded entity) and therefore the treatment of the interest income would be the same regardless of whether ULC is a fiscally transparent entity or a non-fiscally transparent entity. The interesting aspect of this example is that both US SUB and USCO will also be allocated their proportional interest expense deduction in determining their respective U.S. taxable incomes, resulting in actual U.S. tax liability that is not substantively different from the disregarded entity scenario.

Finally, the CRA's comments seem to confirm that payments of interest or royalties by a ULC to an unrelated third party should not be affected by Paragraph 7, as the recipient would be required to include such interest or royalty income as income for U.S. tax purposes regardless of whether ULC is a fiscally transparent entity for U.S. tax purposes.

Each of the above examples illustrates the principles associated with Paragraph 7, Article IV of the Treaty. Treaty benefits and tax positions will be impacted by a taxpayer's specific situation and how the business structure is implemented. Careful consideration of all applicable factors should be considered before adopting or modifying a business structure.

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