tax notes international
Volume 51, Number 7 ■ August 18, 2008

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

From Arbitration to Zero Withholding: A Primer on the Canada-U.S. Treaty Protocol

by Elizabeth Peters and H. David Rosenbloom

Reprinted from *Tax Notes Int'l*, August 18, 2008, p. 603

taxanalysts®
Respectfully disagreeable since 1970.

SPECIAL REPORTS

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

From Arbitration to Zero Withholding: A Primer on the Canada-U.S. Treaty Protocol

by Elizabeth Peters and H. David Rosenbloom

Elizabeth Peters is an associate with Caplin & Drysdale in Washington. H. David Rosenbloom is a member of Caplin & Drysdale and director of the International Tax Program of New York University School of Law.

The fifth protocol[1] to the Canada-U.S. income tax treaty makes significant changes to the treatment of cross-border transactions, including major substantive changes for entities that are fiscally transparent in one of the treaty partners, as well as for pensions, annuities, and stock options. The protocol adds a new permanent establishment test for some services and eliminates the tax on interest in the state of source.

The protocol also adds a mandatory arbitration provision that may allow for the timelier resolution of the inevitable disputes that arise for cross-border transactions and the ensuing mutual agreement proceedings.

Residence

The protocol alters Article IV, the treaty's residence article, adding new rules for dual incorporated companies and fiscally transparent entities.

Dual Incorporated Companies

A change to the treaty in 1995 brought a provision to paragraph 3 of Article IV that treated a company created in one state and continued in the other state (by incorporating there) as a resident of the latter state for purposes of the treaty.[2] This represented a reversal of the rule in the treaty as it had originally entered into force that had assigned treaty residence to the state where the corporation was created — on the theory that creation can occur only once. Some taxpayers took advantage of the 1995 provision by continuing into the other state (typically Canada) and asserting treaty-based rights in the first state (the United States) while simultaneously claiming tax benefits in their state of origin as a domestic corporation.[3] The protocol changes this rule, providing implicitly that a company can be ''created'' under the laws of both states. A company created under the laws of one state but not the other will be considered a resident of the first state, but in all other cases the dual resident will not be treated as a resident of either state for purposes

[1]Protocol Amending the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital Done at Washington on September 26, 1980, as Amended by the Protocols Done on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997.

The protocol is clarified by the U.S. Department of Treasury Technical Explanation. Canada's government has reviewed the technical explanation and ''subscribes'' to its contents. The technical explanation is considered by both the United States and Canada to ''accurately reflect the policies behind particular Protocol provisions, as well as understandings reached with respect to the application and interpretation of the Protocol.'' Technical explanation, Introduction.

[2]The treaty partners, Canada and the United States, will be referred to consistently herein as ''states.''

[3]*See*, *e.g.*, FSA 200117019 (Jan. 24, 2001) (taxpayer claimed under the treaty that a U.S. subsidiary was a Canadian resident for purposes of the treaty, and therefore that dividends from a third country received by the subsidiary were not subject to tax under the Other Income article of the treaty; for U.S. statutory purposes, the taxpayer claimed that the U.S. subsidiary remained a U.S. corporation and could claim foreign tax credits on dividends from foreign affiliates, and that dividends from domestic affiliates were eliminated in consolidation).

Table. Treatment of Entities That Are Fiscally Transparent in at Least One State

	Paragraph 6	Paragraph 7(a)	Paragraph 7(b)
Result	**Treaty benefits allowed**	**Treaty benefits not allowed**	**Treaty benefits not allowed**
Source state views the entity as:	Not a resident of the source state	Not a resident of the owner's state of residence and fiscally transparent	A resident of the source state and not fiscally transparent
Residence state views the entity as:	Fiscally transparent	Not fiscally transparent	Fiscally transparent
Treatment to the taxpayer:	Same as if derived directly[a]	Not the same as if derived directly	Not the same as if derived directly
Example: When Canada is the source state:	U.S. or third-country LLC	Canadian or third-country reverse hybrid entity[b]	Nova Scotia ULC
When the United States is the source state:	Canadian or third-country LLC	U.S. or third-country hybrid	Domestic reverse hybrid entity (*e.g.*, U.S. LP that checks the box to be treated as nontransparent)

[a]For purposes of paragraphs 6 and 7, whether the treatment of an amount derived by the taxpayer is ''the same as its treatment would be if that amount had been derived directly'' is determined in accordance with section 894 and the regulations thereunder concerning whether an entity will be considered fiscally transparent. These rules include that the jurisdiction require the interest holder to separately take into account on a current basis its share of income paid to the entity (regardless of whether distributed) with the character and source of the income remaining the same as in the hands of the entity. Technical Explanation, article 2.

[b]Throughout this article, the terms ''hybrid'' and ''reverse hybrid'' are used from a U.S. perspective. Therefore, a hybrid entity is an entity that is fiscally transparent in the United States and nontransparent in the foreign jurisdiction, and a reverse hybrid entity is an entity that is nontransparent in the United States and fiscally transparent in the foreign jurisdiction.

of claiming benefits under the treaty unless the competent authorities reach agreement on the state of residence. Once the protocol is ratified, this change will apply to corporate continuations effected after September 17, 2000.[4]

Fiscally Transparent Entities

A set of rules in Article IV, paragraphs 6, 7(a), and 7(b) deal with entities that are fiscally transparent under the law of at least one of the states.[5] The rules all pertain to situations in which an entity is interposed between the state that is the source of the income and a taxpayer who is a resident of the other state. The rules differ depending on how the interposed entity is viewed by the source state and the residence state, as illustrated in the table above.

The technical explanation also provides special rules for determining who the beneficial owner is when income is derived through a fiscally transparent entity. The residence state's laws are applied to ascertain who derives the income and whether it will be taken into account for residence state tax purposes. The source state's laws apply to determine whether the person who derives the income is the beneficial owner.[6]

[4]Article 27(3)(a) of the protocol.

[5]Article 2(2) of the protocol. The technical explanation clarifies that fiscally transparent entities for U.S. purposes include ''partnerships, common investment trusts under section 584, grantor trusts, and business entities such as a limited liability company ('LLC') that is treated as a partnership or is disregarded as an entity separate from its owner for U.S. tax purposes,'' and for Canadian purposes include partnerships and ''bare'' trusts. Technical explanation, article 2. Entities that are subject to tax, but for which tax may be relieved under an integrated system, are not considered fiscally transparent entities.

The treatment of S corporations under the protocol will depend on the residence of the beneficial owner of the corporation. If a U.S. resident derives income from an S corporation, the U.S. resident will be considered as the person who derived the income. However, Canada considers an S corporation to be a resident of the United States for purposes of the treaty, and thus (Footnote continued in next column.) allows benefits to the S corporation itself; when the S corporation is owned by a resident of Canada and has U.S.-source income, the income will not be considered derived by the shareholder, but by the corporation itself. Technical explanation, article 2.

[6]Technical explanation, article 2 provides the following example:

> Assume, for instance, that interest arising in the United States is paid to CanLP, an entity established in Canada which is treated as fiscally transparent for Canadian tax purposes but is treated as a company for U.S. tax purposes. CanCo, a company incorporated in Canada, is the

(Footnote continued on next page.)

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Entity Not Resident in the Source State

Under the treaty before the protocol, Canada interpreted the requirement of Article IV that a resident be ''liable to tax'' to mean that the resident must be subject to comprehensive taxation. Therefore, some U.S. hybrid entities, such as U.S. LLCs, did not qualify as residents of the United States. The protocol provides that the owners of a fiscally transparent entity are treated as residents who derive income when the residence state views those owners as liable to tax on the income in question and the treatment of the income in their hands is the same as if it had been received directly by them.[7] This rule does not apply when the fiscally transparent entity is a resident of the source state; that situation is addressed in new Article IV(7)(b).[8]

The technical explanation also clarifies that Canada will apply the provisions of paragraph 6 within its own legal framework (that is, a U.S. LLC is the only person ''visible'' to Canada).[9] This means that a U.S. LLC, and not its owners, will file a Canadian tax return in which it will claim the benefits of the treaty and supply the appropriate documentation.

Paragraph 6 applies to business profits and, therefore, may require a determination whether income was earned through a PE.[10] The determination of whether a PE exists by reason of the business activities of a fiscally transparent entity is determined differently in each state. Canada's determination will be based on the presence and activities in Canada of the U.S. LLC and will not look to activities of the owners acting in their own right; the U.S. LLC will be subject to tax on profits attributable to the PE. In contrast, the United States' determination regarding a Canadian limited partnership will be based on the activities of both the entity and its partners.

Entity Resident in the Source State

When a fiscally transparent entity is viewed as a resident by the source state, different rules apply.[11] Again, this provision deals with entities that the source state considers nontransparent but the residence state perceives as transparent.[12] An example might be a Nova Scotia unlimited liability company (NSULC), considered a nontransparent corporation in Canada but which may be transparent under the check-the-box regime of U.S. law.[13] Before the protocol, if a U.S. investor invested through a NSULC, amounts that the NSULC paid to the U.S. investor would have no U.S. tax effect. Under the protocol, Canada will be able to levy its unreduced statutory tax on dividends paid by the NSULC to the investor because the treatment of those dividends in the United States differs from the treatment that would result if the entity was not transparent.[14]

The Joint Committee on Taxation explanation has noted that this provision is potentially overbroad, as

---

sole interest holder in CanLP. Paragraph 6 of Article IV provides that CanCo derives the interest. However, if under the laws of the United States regarding payments to nominees, agents, custodians and conduits, CanCo is found be a nominee, agent, custodian or conduit for a person who is not a resident of Canada, CanCo will not be considered the beneficial owner of the interest and will not be entitled to the benefits of Article XI with respect to such interest. The payment may be entitled to benefits, however, if CanCo is found to be a nominee, agent, custodian or conduit for a person who is a resident of Canada.

[7]Article 2(2) of the protocol.

[8]Therefore, the rule of paragraph 6 applies to any U.S. owner deriving income through a non-Canadian resident entity that is fiscally transparent in the United States or any Canadian owner deriving income through a non-U.S. resident entity that is fiscally transparent in Canada.

[9]Technical explanation, article 2.

[10]Technical explanation, article 2.

[11]Article IV(7) becomes effective three years after the protocol enters into force. *See* article 27(3)(b) of the protocol.

[12]The technical explanation notes that this provision would cover situations in which a payment is viewed under Canadian tax law as a dividend, but under U.S. tax law as a partnership distribution, for a dividend paid by an entity that is a corporation for Canadian purposes but a partnership (as opposed to being disregarded) for U.S. purposes. Also, this would cover a U.S. limited partnership (LP) owned by a Canadian corporation that is considered to be a corporation in the United States, but is considered under Canadian law to be a branch of the Canadian corporation. The payment from the U.S. LP is treated as a branch remittance for Canadian tax purposes, whereas if Canada regarded the U.S. LP as a corporation the payment would be treated as a dividend. Technical explanation, article 2.

The Joint Committee on Taxation notes that there are no examples relating to deductible interest or royalty payments from a hybrid partnership. The U.S. recipient of a payment from a hybrid partnership would treat the payment as interest or a royalty. Therefore, the JCT concludes that ''one might expect that subparagraph 7(b) would not apply'' in this situation. Joint Committee on Taxation, Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada (JCX-57-08), July 8, 2008 [hereinafter referred to as the JCT explanation], at p. 103.

[13]Treas. reg. sections 301.7701-2, -3.

[14]The section 894(c) domestic reverse hybrid regulations have already purported to restrict abusive uses of such a structure when an item of income is paid by a domestic reverse hybrid to a related party. *See* Treas. reg. section 1.894-1(d)(2)(ii). A domestic reverse hybrid entity is a U.S. domestic entity treated as not fiscally transparent in the United States but fiscally transparent in the interest holder's jurisdiction.

The technical explanation notes that for payments that are covered under paragraph 7, section 894(c) and the regulations thereunder are not relevant. Presumably, this is because a person covered by the provision is not entitled to the benefits of the treaty under the plain language of the treaty. Technical explanation, article 2.

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

there may be legitimate reasons for a U.S. company to use a Canadian unlimited liability company for operations in Canada.[15] As a result of paragraph 7(b), many taxpayers that had not structured their Canada-U.S. operations to take advantage of double deductions will need to restructure to avoid double taxation.

Not a Resident of the Residence State

The protocol adopts new rules governing the treatment of entities that are fiscally transparent in the state of source and taxable in the owner's state of residence. The owner of such an entity that the source state does not consider a resident of the owner's state of residence does *not* derive income for purposes of the treaty if the treatment of the income is different, in the view of the residence state, than if the income had been derived directly by the owner. This rule is a Canadian analogue to section 894(c) of the U.S. Internal Revenue Code, which denies treaty benefits for U.S.-source income when not considered received by a resident of the treaty partner. However, unlike section 894(c), which is concerned only with reduced withholding tax rates on payments to domestic reverse hybrids, the protocol denies all treaty benefits, including the PE threshold for determining the taxation of business profits.

For example, under preprotocol law, if a U.S. person invests in Canada through a Canadian entity that Canada views as a partnership but that the United States perceives as a corporation (by reason of the check-the-box rules), income paid from Canada to the entity would qualify for treaty relief in Canada (because Canada would see the U.S. investor as recipient of the income). However, since the United States views the entity as nontransparent, the income reaches the U.S. investor only when the entity pays out a dividend. This structure provides a treatment for the investor that is entirely different from the treatment that would apply if the income was paid directly to the U.S. investor.

Services Permanent Establishment

The protocol adds a new services PE concept, which does not require an office or fixed place of business.[16] Similar rules have commonly appeared in U.S. tax treaties in the developing world.[17] The provision deems a PE to exist if (1) services are performed in the source state by an individual who is present in that state for a period of 183 days or more in any 12-month period and more than 50 percent of the gross active business revenues of the enterprise are attributable to those services,[18] or (2) services are performed in the source state by an enterprise for a period of 183 days or more in any 12-month period with respect to the same or connected projects for customers who are residents of the source state, or who have a PE in the source state and the services are provided for that PE.[19] How days are counted varies slightly for each test.[20] Under the first test, ''days'' refers to any day an individual is present in the source state. Under the second test, only working days, not nonworking days (for example, weekends and holidays), count toward satisfaction of the 183-day test. For both tests, even if multiple individuals work on a project on a given day, their collective presence accounts for only one day under the test. The technical explanation clarifies that only services provided by an enterprise to third parties within the source state are covered by this new provision.[21]

The services PE rule is likely to pose compliance and administration issues. Tracking employees' days abroad will be difficult for both taxpayers and tax administrations and will require taxpayers to establish systems and processes.[22] The 183-day rule applies regardless of calendar or fiscal years, and therefore records must be reviewable for any consecutive 12-month period. Whether different services projects can

---

[15]These may include: to operate in branch form for U.S. tax purposes, to better manage Canadian foreign taxes for U.S. purposes, and to increase its Canadian tax basis in Canadian assets acquired through a purchase of the stock of a Canadian company. JCT explanation, at p. 100.

[16]This provision is intended to reverse the result of the Canadian Federal Court of Appeal decision in *The Queen v. Dudney*, 99 DTC 147 (T.C.C.), *aff'd* 2000 DTC 6169 (F.C.A.). JCT explanation, at p. 95.

[17]The services PE provision generally follows the U.N. model convention and the OECD's proposed draft services PE rule.

[18]The term ''gross active business revenues'' is defined further in the technical explanation. Those revenues are gross revenues ''attributable to active business activities that the enterprise has charged or should charge for its active business activities, regardless of when the actual billing will occur or of domestic law rules concerning when such revenues should be taken into account for tax purposes.'' The active business activities are not restricted to the provision of services, but they do not include income from passive investments. Technical explanation, article 3.

[19]Article 3(2) of the protocol.

[20]Technical explanation, article 3.

[21]Technical explanation, article 3. Therefore, it is not sufficient that the relevant services be merely furnished to a resident of the source state. For example, ''where . . . an enterprise provides customer support or other services by telephone or computer to customers located in the other State, those would not be covered by [the services PE rule] because they are not performed or provided by that enterprise within the other State.'' Technical explanation, article 3.

[22]The JCT explanation notes that taxpayers will probably not have permanent employees in the source state to implement the taxpayer's tax compliance efforts, including paying estimated taxes and filing tax returns. JCT explanation, at p. 96. Also, it may be difficult for taxpayers to know if they have a services PE until after one has been established.

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

properly be considered the ''same or connected'' is also likely to give rise to disagreements.[23] Finally, the protocol and technical explanation do not address whether the use of a subcontractor might give rise to a PE of a general contractor under this new provision.[24]

The provision is effective for the third tax year after the protocol enters into force, but in no event do activities that occur or arise before January 1, 2010, count toward the determination of a services PE.[25] This delayed effective date may permit the tax authorities to issue additional guidance.

Attribution of Profits

An exchange of notes appended to the protocol clarifies that the OECD transfer pricing guidelines will apply for purposes of determining profits attributable to a PE.[26] In particular, business profits attributable to a PE will include only profits derived from assets used, risks assumed, and activities performed by the PE. The exchange of notes further provides that a PE will be treated as having the same amount of capital that it would need to support its activities if it were a distinct and separate enterprise engaged in similar activities. The technical explanation also provides that, in calculating the business profits of a PE, deductions will not be limited to expenses incurred exclusively for the PE but will also include expenses incurred for purposes of the enterprise as a whole, and that deductions are to be allowed regardless of which accounting unit of the enterprise books the expenses, as long as they are incurred for the purposes of the PE.[27]

Dividends

REIT Provisions

The protocol updates the REIT provisions of Article X (Dividends) to make them consistent with the current U.S. model. It thus adds changes to the limitations on rate reduction for dividends paid by a REIT. The treaty-reduced 15 percent tax on dividends will apply when dividends are paid for a class of stock that is publicly traded and the beneficial owner of the dividends is a person holding an interest of not more than 5 percent of any class of the REIT's shares; when the beneficial owner of the dividends is an *individual* holding an interest in the REIT of not more than 10 percent; or when the beneficial owner of the dividends is a *person* holding an interest in the REIT of not more than 10 percent and the REIT is not ''diversified.'' The technical explanation defines the term ''diversified'' as when the gross value of no single interest in real property held by the REIT exceeds 10 percent of the gross value of the REIT's total interests in real property.[28]

Fiscally Transparent Entities

The protocol also includes updates to address dividends paid through fiscally transparent entities. The rate at source is reduced to 5 percent if the beneficial owner is a company that owns 10 percent of the voting stock of the company paying the dividends. For this purpose, the ownership of 10 percent of voting stock includes voting stock owned by a fiscally transparent entity, as seen by the residence state, in proportion to a company's ownership interest in the fiscally transparent entity. However, the fiscally transparent entity cannot be a resident of the source state for this provision to apply.[29]

Interest and Guarantee Fees

In perhaps the most economically significant development of the protocol, article 6 eliminates the source-basis tax on interest payments between unrelated parties. The preprotocol 10 percent rate is gradually phased out for interest paid or credited to related persons, from 7 percent during the first calendar year that ends after the protocol's entry into force, to 4 percent

[23]An exchange of notes clarifies that projects are considered connected if they constitute a coherent whole, commercially and geographically. *See* Annex B, exchange of notes (Sept. 21, 2007), at para. 2. The technical explanation clarifies that this determination is made from the point of view of the enterprise (not that of the customer) and depends on facts and circumstances, including whether the projects would have been concluded under one contract (in the absence of tax planning), whether the nature of the work involved in the projects is the same, and whether the same individuals work on both projects. Technical explanation, article 3.

The technical explanation states that when ''a technology consultant is contracted to install a particular computer system for a company, and is also hired by the same company, pursuant to a separate contract, to train its employees on the use of another computer software that is unrelated to the first system,'' commercially coherent projects are lacking and therefore days spent on each contract may not be aggregated.

[24]*See* JCT explanation, at pp. 97-98.

[25]Article 27(3)(c) of the protocol.

[26]Annex B, exchange of notes, at para. 9.

[27]Technical explanation, article 4.

[28]Technical explanation, article 5. For purposes of the diversification test, the technical explanation provides that foreclosure property is not considered an interest in real property, and a REIT holding a partnership interest is treated as owning its proportionate share of the real property held by the partnership.

[29]Article 5(1) of the protocol. The technical explanation explains that the provision addressing fiscally transparent entities is only a ''clarification'' to the preprotocol treaty. Technical explanation, article 5.

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

in the second year, to 0 percent for subsequent years.[30] The protocol provides that contingent interest will be taxed at a rate of 15 percent if it does not qualify as portfolio interest. Interest that is an excess inclusion from a real estate mortgage investment conduit is taxable according to domestic law.

Additionally, the protocol adds a new sourcing rule for guarantee fees in Article XXII (Other Income). Compensation received for a guarantee is taxable only in the state of residence unless the compensation is considered business profits attributable to a PE in the source state.[31]

Pensions, Annuities, and Stock Options

Retirement Plans

The protocol makes major changes to Article XVIII (Pensions and Annuities), amending one paragraph and adding two new paragraphs regarding cross-border contributions to, and benefits accrued under, qualified retirement plans.[32] The revised article defines a qualifying retirement plan as a resident of a state, generally exempt from income tax in that state, and that is operated primarily to provide pension or retirement benefits; that is not an individual arrangement in respect of which the individual's employer has no involvement; and that the competent authority of the source state perceives as resembling a pension or retirement plan recognized in its state.[33]

The main provisions addressing cross-border retirement plans are found in new paragraphs 8, 10, and 13 added to Article XVIII of the treaty. Distributions from pensions or retirement plans that are reasonably attributable to a contribution or benefit for which a benefit was allowed under one of these paragraphs are deemed to arise in the state where the plan is established.[34]

Paragraph 8 allows deductions and exclusions for contributions to, and benefits accrued under, qualifying plans in one state for services of individuals conducted in the other (source) state on short-term assignments.[35] For example, Canada will allow deductions or exclusions for contributions to a U.S. qualifying retirement plan by individuals working in Canada who meet the prescribed conditions. For a U.S. citizen, the benefits granted shall not exceed those granted for U.S. residents under U.S. retirement plans recognized for tax purposes. In addition, contributions made to the residence state plan by the individual's employer will be allowed as a deduction in computing the employer's profits in the source state.[36]

---

[30]Article 27(3)(d) of the protocol.

[31]The technical explanation states that compensation paid to a financial services company to provide a guarantee in the ordinary course of business constitutes business profits under Article VII (Business Profits). Guarantees made with respect to related-party debt are not an ordinary independent economic undertaking that would generate business profits, and therefore, are ordinarily treated under Article XXII (Other Income).

[32]Article 13, paras. 2 and 3, of the protocol.

[33]Article XVIII(15). The protocol clarifies that pensions include Roth IRAs. The exchange of notes provides that qualified retirement plans include the following: qualified plans under section 401(a) of the Internal Revenue Code (including section 401(k) arrangements); individual retirement plans that are part of a simplified employee pension plan that satisfies section 408(k); section 408(p) simple retirement accounts; section 403(a) qualified annuity plans; section 403(b) plans; section 457(g) trusts providing benefits under section 457(b) plans; the Thrift Savings Fund (section 7701(j)); and any individual retirement account under section 408(a) that is funded exclusively by rollover contributions from one or more of the preceding plans. For Canada, the term ''qualifying retirement plan'' includes the following: registered pension plans under section 147.1 of the Income Tax Act; registered retirement savings plans under section 146 that

(Footnote continued in next column.)

are part of a group arrangement described in subsection 204.2(1.32); deferred profit-sharing plans under section 147; and any registered retirement savings plan under section 146 or registered retirement income fund under section 146.3 that is funded exclusively by rollover contributions from one or more of the preceding plans. *See* Annex B, exchange of notes, at para. 10. If a particular plan is not specifically listed as a qualified retirement plan, a taxpayer may request a determination from the competent authority that a plan qualifies. Technical explanation, article 13.

[34]Article XVIII(16).

[35]Article XVIII(8). To qualify, the individual must perform services as an employee in the source state; the remuneration must be taxable in that state; the contributions and benefits must be attributable to those services; and the contributions and benefits must be made or accrued during the period in which the individual performs those services. The individual must also have been participating in that retirement plan (or a similar plan) immediately before performing services in the source state. Also, the individual must not have performed services in the source state for the same employer for more than 60 of the last 120 months, and if an individual receives benefits in the source state for contributions made in the residence state, the services to which the contributions relate may not be taken into account for purposes of determining the individual's entitlement to benefits under a retirement plan in the source state, and the individual must not have been a resident (as determined by Article IV (Residence)) of the source state immediately before he began performing services in the source state. *See* Technical explanation, article 13.

[36]The technical explanation clarifies that the deduction is allowed even though such a deduction might not be otherwise allowable under the domestic law of the source state. *See* technical explanation, article 13.

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Conversely, the protocol provides in new paragraph 10 of Article XVIII that an individual's state of residence will allow deductions and exclusions for payments to source state plans when the individual's contributions are attributable to services performed in the source state.[37] For example, Canada will allow deductions or exclusions for contributions made to a qualifying plan in the United States by a Canadian resident working in the United Sates, a provision that addresses cross-border commuters. For purposes of Canadian taxation, benefits are limited to the deduction limit under registered retirement savings plans less actual contributions to those plans, and the amount deducted is taken into account in computing the deduction limit for subsequent years. For purposes of U.S. taxation, the benefits cannot exceed those allowed under a generally corresponding pension or retirement plan in the United States and, in making this calculation, contributions to a Canadian plan are treated as if made to a U.S. plan.

Special rules apply, under new paragraph 13 of Article XVIII, to citizens of the United States who are resident in Canada. These taxpayers may receive a deduction or exclusion for purposes of U.S. tax for plan contributions qualifying for tax benefits in Canada.[38] However, these benefits may not exceed those that would be available to a U.S. resident with respect to a generally corresponding U.S. plan, and this provision applies only to services for a resident of Canada or a Canadian PE.

Annuities

Annuities or other amounts paid periodically under an annuity or life insurance policy will be taxed in the source state unless the payment is borne by a PE outside the state of residence and the obligation giving rise to the annuity is incurred in connection with the PE.[39]

Stock Options

The tax treatment of stock options was not previously addressed in the treaty. This treatment was an important subject for the negotiations, since stock options are frequently granted to employees who migrate between Canada and the United States. For employees whose principal place of employment spans the United States and Canada between the grant date and the exercise date, the protocol provides specific sourcing rules.[40] The employee will be deemed to have derived in a state the proportion of income equal to the number of days his ''principal place of employment'' for the employer was in that state over the total number of days between the grant date and the exercise date. The technical explanation provides that the residence state will have the right to tax all of the income arising from the exercise of the option. Under the exchange of notes, the source state is entitled to tax a portion of the income only after the tests of Article XV(2) (that is, that the remuneration did not exceed $10,000 or that the recipient is present in the source state for a period not exceeding in the aggregate 183 days in any 12-month period and that the remuneration is not paid by a person who is a resident of the source state or borne by a PE in the source state) are applied to the years in which the relevant services were performed in the source state. To the extent that income is subject to tax in both states, double taxation is alleviated under Article XXIV (Elimination of Double Taxation).[41]

The new limitation on benefits provision will be applied reciprocally. Previously, LOB provisions applied only to benefits claimed in the U.S.

However, the competent authorities may agree that the terms of a stock option were such that the grant of the option is appropriately treated as a transfer of the stock, and in that event, income will be attributed accordingly. The exchange of notes suggests this may be the case when the options were in-the-money or not subject to a substantial vesting period.

Limitation on Benefits

The protocol's limitation on benefits provision is generally similar to other LOB provisions in recent U.S. treaties. The biggest change is that the new provision will be applied reciprocally. Under the treaty before the protocol, LOB provisions applied only to benefits claimed in the United States. Perhaps because of the recent loss by the Canadian government in a case

[37]Article XVIII(10). For paragraph 10 to apply, the individual must perform services as an employee in the source state, the remuneration of that employment must be taxable in the source state, and the remuneration must be borne by either a source state employer or a PE in the source state. Article XVIII(10) and technical explanation, article 13.

[38]Article XVIII(13).

[39]Article XVIII(4).

[40]*See* Annex B, exchange of notes, at para. 6. In more recent treaties, the United States has explicitly addressed the allocation of taxing rights for stock options. *See*, *e.g.*, Exchange of Diplomatic Notes Accompanying the U.K.-U.S. Tax Treaty (July 24, 2001).

[41]Technical explanation, article 10.

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

involving treaty shopping,[42] the new provision will apply to Canadian benefits as well.

The protocol also makes changes to the requirements for treaty benefits under the LOB rules. It tests ownership not only of the vote and value of shares, but also of the vote and value of ''each disproportionate class of shares.'' A disproportionate class means any class of shares of a company resident in one of the states that entitles the shareholder to a disproportionately higher participation, through dividends, redemption payments, or otherwise, in earnings generated in the other state from particular assets or activities of the company.[43] Also, the protocol removes the entitlement to benefits for companies owned by U.S. persons (that is, residents or citizens of the United States); the publicly traded test and the base erosion test now provide that only ownership by ''qualified persons'' satisfies the test.[44] The protocol also clarifies that, for the base erosion test, the amount of expenses deductible from gross income is determined by the state of residence of the company, and that direct or indirect payments to nonqualifying persons in excess of 50 percent will disqualify a company for benefits.[45]

The exchange of notes clarifies that because the United States and Canada are part of the same regional free trade area, publicly traded companies resident in one of the states may satisfy the publicly traded limitation on benefits test if their shares are traded on the stock exchange in the other state.[46] However, in making future amendments to the treaty, modifications may be made, including alterations to discourage corporate inversion transactions.[47]

Arbitration

One of the most anticipated changes to the treaty is a new mandatory arbitration provision outlined in the protocol and elaborated on in the exchange of notes. There has been an increasing number of cases of double taxation that have not been resolved satisfactorily through the mutual agreement procedure (MAP). In 2005 the two governments issued two memorandums of understanding on the MAP process in an effort to improve the process.[48]

The protocol's mandatory arbitration provision covers disputes only under Article IV (Residence) insofar as they relate to natural persons, Article V (Permanent Establishment), Article VII (Business Profits), Article IX (Related Persons), and under Article XII (Royalties) as it applies to transactions involving related persons and royalty disputes arising under paragraphs 2 or 3 of that article.[49] This may be because the negotiators were interested in arbitration for disputes that are mostly factual in nature. Any case may be found not suitable for arbitration, if the competent authorities so agree.

The dispute resolution technique adopted in the protocol is based on that used in baseball arbitration: Each state submits a proposed disposition of the specific amounts of income, expense, or tax in dispute, and a three-member arbitration panel chooses one of the proposals.[50] The states will prepare position papers supporting their proposals and may, if they desire, prepare reply submissions to the other state's submission. Additional information may be submitted to the arbitration panel only at its request. The panel will apply the provisions of the treaty, any agreed commentaries or explanations of the treaty, the laws of the states to the

---

[42] *MIL (Investments) S.A. v. The Queen*, [2006] 5 CTC 2552 (TCC).

[43] *See* Article XXIXA(5)(b). The protocol also defines the term ''principal class of shares'' used to determine the publicly traded test under Article XXIXA(2)(c). The technical explanation provides an example of a situation in which a corporation will not qualify for benefits due to a disproportionate class of shares:

> OCo is a corporation resident in Canada. OCo has two classes of shares: Common and Preferred. The Common shares are listed and regularly traded on a designated stock exchange in Canada. The Preferred shares have no voting rights and are entitled to receive dividends equal in amount to interest payments that OCo receives from unrelated borrowers in the United States. The Preferred shares are owned entirely by a single investor that is a resident of a country with which the United States does not have a tax treaty. The Common shares account for more than 50 percent of the value of OCo and for 100 percent of the voting power. Because the owner of the Preferred shares is entitled to receive payments corresponding to the U.S.-source interest income earned by OCo, the Preferred shares are a disproportionate class of shares. Because the Preferred shares are not primarily and regularly traded on a recognized stock exchange, OCo will not qualify for benefits under subparagraph 2(c).

Technical explanation, article 25.

[44] *See* Article XXIXA(2), subparas. (d) and (e).

[45] *See* Article XXIXA(2)(e). *See also* Article XXIXA(4) (changing the similar base erosion component of the derivative benefits test).

[46] Article XXIXA 2(c).

[47] *See* Annex B, exchange of notes, at para. 14.

[48] *See* Memorandum of Understanding Between the Competent Authorities of Canada and the United States Regarding the Mutual Agreement Procedure (June 3, 2005) and Memorandum of Understanding Between the Competent Authorities of Canada and the United States Regarding Factual Disagreements Under the Mutual Agreement Procedure (Dec. 23, 2005).

[49] In contrast, the mandatory arbitration provision in the Belgium-U.S. tax treaty covers all matters falling under the jurisdiction of the competent authorities.

[50] The arbitration board will consist of one person chosen by each state and a third person (not a citizen of either state) chosen by the first two.

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

extent they are not inconsistent with each other, and any OECD materials regarding relevant portions of the OECD model convention.[51]

The resolution of arbitration proceedings is binding on the states. A taxpayer may reject the final decision of the panel, but if the decision is rejected, the taxpayer is precluded from further arbitration proceedings. The competent authorities may also terminate arbitration proceedings before a decision if they come to a mutually agreeable solution. The arbitration panel will not provide a rationale for its decision, and the resolution is not precedential.

The dispute resolution technique adopted in the protocol is based on that used in baseball arbitration.

A central issue under the arbitration provision is what to do with MAP cases already in the pipeline. By its terms, the protocol contemplates that arbitration will begin no earlier than two years after it enters into force, unless the competent authorities agree otherwise. Assuming all cases will need to wait the full two years, a significant number of backlogged cases are likely to go to arbitration at precisely the same time, potentially creating resource issues. It is therefore hoped that the competent authorities will agree to consider some of the approximately 60 cases that have already been stalled for over two years.[52] Many taxpayers and practitioners are also hopeful that the prospect of mandatory arbitration will help to bring cases to resolution outside a formal arbitration process. The format of baseball arbitration, in which the arbitrators pick the more reasonable and rational proposal, should help to restrain the more extreme positions of both states.

Other Noteworthy Provisions

Article XXI (Exempt Organizations)

The exemption for dividends and interest in the source state is extended to amounts derived for the benefit of a religious, scientific, literary, educational, or charitable organization.[53]

Article XXV (Non-Discrimination)

The nondiscrimination provisions are extended from citizens to nationals, including entities. The provision also applies to individuals who are not residents of either state.[54]

Article XXVII (Exchange of Information)

The protocol expands the exchange of information provision to allow representatives to interview individuals and examine books and records and to prohibit a state from declining to supply information because it is held by a financial institution, nominee, or other person acting in an agency or fiduciary capacity.[55]

Article XXIX (Miscellaneous Rules)

Former citizens and long-term residents of the United States may, for a period of 10 years following the loss of such status, be taxed in accordance with the laws of the United States on income from sources within the United States (including income deemed under the domestic law of the United States to arise from such sources).[56] Under special rules, U.S.-source

---

[51]The technical explanation is presumably an ''agreed commentary or explanation'' as to the meaning of the convention.

[52]The technical explanation signals that the competent authorities may attempt to address this issue. It provides:

> To avoid the potential for a large number of MAP cases becoming subject to arbitration immediately upon the expiration of two years from entry into force, the competent authorities are encouraged to develop and implement procedures for arbitration by January 1, 2009, and begin scheduling arbitration of otherwise unresolvable MAP cases in inventory (and meeting the agreed criteria) prior to two years from entry into force.

Technical explanation, article 27.

[53]Article XXI(3)(a). The technical explanation explains that this revised paragraph now allows charitable organizations to invest in pooled funds with trusts, companies, organizations, or other arrangements that are operated to provide pension or retirement benefits. Previously, the IRS had ruled that a pooled investment fund that included charitable investors would not be exempt from taxation on dividend and interest income arising in the other state. Technical explanation, article 16.

[54]An important factor in the analysis is whether the persons being compared are both taxable on worldwide income. Technical explanation, article 20. For example, nonresident U.S. citizens are subject to tax on their worldwide income and, therefore, are not in the same circumstances regarding U.S. taxation as citizens of Canada who are not U.S. residents. Thus, the application of the provision to individuals who are not residents of either state will have effect only in Canada.

[55]The exchange of notes clarifies that the standards and practices in Article XXVII (Exchange of Information) of the treaty are to be in no respect less effective than those described in the Model Agreement on Exchange of Information on Tax Matters developed by the OECD Global Forum Working Group on Effective Exchange of Information. Annex B, exchange of notes, at para. 13.

[56]A long-term resident is defined as an individual who is a lawful permanent resident of the United States in 8 or more tax years during the preceding 15 tax years. For these purposes, years when the individual is treated as a resident of Canada under the treaty, or as a resident of any other country except the United States under another U.S. tax treaty, and the individual

(Footnote continued on next page.)

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

income includes gains from the sale or exchange of stock of a U.S. company or debt obligation of a U.S. person or governmental entity, gains from property located in the United States, and in certain cases income or gains derived from the sale of stock of a non-U.S. company or the disposition of property contributed to a non-U.S. company when such company would be a controlled foreign corporation if the person had remained a U.S. person.[57]

Conclusion

The protocol makes significant updates to the treaty to bring it into line with current U.S. treaty policy. However, two new provisions, the services PE rule and the treatment of certain fiscally transparent entities, represent departures from general U.S. treaty policy. Taxpayers will need to consider restructuring their operations to accommodate these provisions. Fortunately, the effective date for both provisions is delayed, allowing time for necessary compliance and organizational changes.

Importantly, the protocol also introduces mandatory arbitration. Arbitration should improve the ability of the competent authorities to settle disputes in a timely manner. However, it will be crucial for the competent authorities to agree on an orderly process to decide how to handle the many cases that have already been submitted for mutual agreement. It is hoped that some of these cases may be considered before the two-year waiting period envisioned by the protocol. ◆

---

does not waive the benefits of such treaty, will not count. *See* Annex B, exchange of notes, at para. 11.

[57]Annex B, exchange of notes, at para. 12. It is not clear whether these changes will have any effect in light of the enactment of section 877A, which adopts a mark-to-market regime for the preexisting 10-year taxation of U.S.-source income, applicable after June 16, 2008.

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.