

THE NEW CANADA-U.S. TAX TREATY
AND THE LIMITATION ON BENEFITS
PROVISION

A Justifiable Compromise?

by

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ABSTRACT

On November 9, 1995, Canada and the United States ratified the Third Protocol to the Canada-U.S. Income Tax Convention. The Protocol will benefit Canadians engaged in cross-border business as it eliminates many pre-existing tax barriers to trade and investment. However, the Protocol also includes a controversial Limitation on Benefits ("LOB") Article, intended to prevent treaty shopping by Canadian resident entities.

This thesis will analyze the LOB Article and examine its problems and the potential pitfalls which Canadian taxpayers should be aware of when conducting cross-border trade and investment. These problems fall into five categories. First, the LOB Article is difficult to apply in practice because it contains complex tests and several undefined and vague terms. Second, the LOB Article has the potential to deny treaty benefits to entities engaged in *bona fide* non-treaty shopping activities. Third, Canadian resident entities which have, or plan to have, U.S. source income will be required to take into account the LOB Article's extremely complex rules and plan appropriately whenever there is a change in the share ownership of their Canadian businesses or an increase in the level of expense payments to third country residents. They will have to conduct regular reviews to ensure that they are in compliance with the LOB Article. Fourth, the LOB Article could have the unplanned effect of re-directing tax revenues from Canada to the U.S. Finally, the LOB Article violates two of the three goals of tax treaty policy: the prevention of double taxation and the promotion of stability.

This thesis concludes that the inclusion of the LOB Article in the Protocol was politically and bureaucratically motivated by U.S. tax authorities' zeal to halt treaty shopping at all costs. The inclusion of the LOB Article demonstrates the preoccupation of the U.S. with eliminating treaty shopping. This preoccupation appears to take precedent over the basic goal of international tax treaties, which is the facilitation of trade and investment through the removal of tax barriers to the free exchange of capital, goods and services. Further, this thesis concludes that Canada should not have conceded to the inclusion of the LOB Article in the Protocol because its negative impact on some

Canadian entities and the Canadian economy will outweigh the Protocol's potential benefits for Canada.

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INTRODUCTION

As the twentieth century draws to a close, the global economic community has been experiencing a rapid increase in international trade and investment. Additionally, manufacturing, trade in goods and services, and investment activities are also becoming integrated on an international level.¹ Economic integration has accelerated in response to spectacular advances in the speed and efficiency of communications and transportation and the liberalization of trade and investment policies.² For instance, in North America Canadian and U.S. cross-border trade has increased to the point where Canada and the U.S. are currently each others largest trading partners.³

The goals of bilateral agreements such as the Canada-U.S. Free Trade Agreement, the General Agreement on Tariffs and Trade, the North American Free Trade Agreement⁴ and the Canada-U.S. Tax Treaty are to facilitate cross-border trade and investment.⁵ Although the North American Free Trade Agreement ("NAFTA") does not directly affect the tax consequences of cross-border investment, it has raised expectations that income

¹ Mimi E. Gild, *Tax treaty shopping: Changes in the U.S. Approach to Limitation on Benefits Provisions in Developing Country Treaties*, 30 Va J. Int'l L. 553 (1990).

² The Honourable Paul Martin, P.C., M.P., Minister of Finance, *A New Framework for Economic Policy* (Sept. 18, 1994). Hereinafter referred to as 'Framework for Economic Policy'.

³ Cross-border trade within North America will be further enhanced by the North American Free Trade Agreement that creates a market with over 360 million consumers and over \$6.4 trillion (U.S.) in annual output. Rodney H. Standage, *Policies of Income Tax Treaties and the U.S.-Mexico Income Tax Treaty*, 29 Gonz. L. Rev. 165 (1993).

⁴ On December 17, 1992, the United States, Canada and Mexico signed the North American Free Trade Agreement ("NAFTA"), North American Free Trade Agreement, Dec. 8-17, 1992, 32 I.L.M. 289; 32 I.L.M. 605. Following enactment of implementing legislation by each country, NAFTA entered into force on January 1, 1994. The primary goals of NAFTA are to: (1) eliminate barriers to trade and facilitate cross-border movement of goods and services; (2) promote conditions for fair competition; (3) increase investment opportunities in the three countries; (4) protect intellectual property rights; and (5) provide administrative and dispute resolution procedures. Paul R. McDaniel, *Colloquium on NAFTA and Tradition: Formulary Taxation in the North American Free Trade Zone*, 49 Tax L. Rev. 691, 692-93 (1994).

⁵ Brian J. Arnold and Neil H. Harris, *Colloquium on NAFTA and Tradition: NAFTA and the Taxation of Corporate Investment: A View From Within NAFTA*, 49 Tax L. Rev. 529, 530 (1994). The Free Trade Agreement and the North American Free Trade Agreement are important first steps in creating a more hospitable environment for cross-border investment within North America. These steps may lead to increased harmonization of the U.S. and Canada's tax systems, as has occurred in the European Community. *Ibid.* at 531.

tax impediments to free trade will be reduced through bilateral or multilateral tax treaties.⁶ Tariffs and legal restrictions on foreign investment are obvious barriers to cross-border trade and investment.⁷ However, the potential tax consequences of cross-border and international business transactions can also have a large influence on whether these transactions are carried out, and in what manner they will be carried out. Tax considerations become an important concern particularly when non-tax barriers to investment are eliminated.⁸ One important consideration is that international business transactions may be subject to taxation in more than one jurisdiction, commonly referred to as "double taxation".⁹ To eliminate the problem of "double taxation" countries negotiate bilateral income tax treaties to allocate taxing jurisdiction in a way that will encourage trade and investment.¹⁰ "The principal function of income tax treaties is to facilitate international trade and investment by removing – or preventing the erection of – tax barriers to the free international exchange of goods and services and the free international movement of capital and persons."¹¹

On November 9, 1995, in recognition of North America's increasingly integrated and dependent economies, Canada and the United States ratified the Third Protocol to the Canada-U.S. Income Tax Convention, 1980¹² (hereinafter the 'Protocol' and the 'Convention' respectively). The Protocol significantly improves the Convention as it eliminates many pre-existing tax barriers to trade and investment. The Protocol benefits

⁶ John P. Steins, JR., *Colloquium on NAFTA and Tradition: Commentary: Income Tax Implications of Free Trade*, 49 Tax L. Revenue. 675 (1994).

⁷ *Ibid.* at 531.

⁸ *Ibid.*

⁹ The jurisdiction to tax can arise from the source of income, the residence of the taxpayer or and, in the case of the United States, from citizenship. Thus, a corporation that is resident in Canada and conducts business in the U.S. will be subject to tax in the U.S. on its U.S. source income and will be subject to tax in Canada on that same income because Canada taxes residents on their world wide income.

¹⁰ See *supra* note 1 at 554.

¹¹ Federal Income Tax project, International Aspects of United States Income Taxation II, Proposals on United States Income Tax Treaties, American Law Institute 1 (1992). Hereinafter 'ALI Tax Treaty Project.'

¹² 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, March 28, 1984, and November 9, 1995. The majority of the Protocol's provisions became effective on January 1, 1996.

Canadians who invest or transact business in the United States by reducing withholding taxes on branch profits, dividends, interest and royalties. The Protocol also reduces U.S. estate tax for Canadians with U.S. property holdings and it eliminates the double taxation of pensions and annuities received by Canadians residing in the U.S.¹³ Therefore, the Protocol can be seen as a favorable complement to NAFTA as its provisions lessen several tax deterrents to trade and investment between Canada and the United States.¹⁴

Despite its favorable improvements, the Protocol also includes the controversial Limitation on Benefits ("LOB") Article. This Article is aimed at reducing treaty shopping by preventing non-treaty country residents from obtaining treaty benefits.¹⁵ However, while the intent of the LOB Article is to reduce treaty shopping, it may have an adverse impact upon Canadians not engaged in this activity. Moreover, the LOB Article introduces a new level of complexity and uncertainty in the international tax arena.

The objective of my thesis is to analyze the LOB Article and to describe its negative effects and the potential pitfalls tax practitioners should consider when advising clients who conduct, or are contemplating, cross-border trade and investment. I shall accomplish this objective by first, in chapter one, discussing the goals of tax treaties and the problem of treaty shopping. I shall then, in chapter two, briefly examine the changes the Protocol brings to the Convention. In chapter three, I shall discuss U.S. tax treaty policy and the reasons why the LOB Article was included in the Protocol. In chapter four, I shall analyze, in detail, the LOB Article in the Protocol. This will involve a description of the LOB Article and its operation, an analysis of its impact and the potential problems it creates, and a discussion of any tax planning opportunities it presents. Finally, in Chapter

¹³ The Protocol negotiations were motivated by the exacerbating affects on overall death taxes for Canadians owning U.S. property. The negotiations evolved from the problem of death taxes to issues involving cross-border taxation and treaty shopping. Nathan Boidman, *The 1995 Canada-U.S. Treaty Protocol: Some Reflections*, 96 Tax Notes Int'l 48-15 (March 11, 1996).

¹⁴ *Protocol to Canada-U.S. Tax Treaty Signed*, 380 Tax Notes 3 (September 14, 1994).

¹⁵ While tax treaties allocate taxing jurisdiction in a way that will encourage trade and investment, they sometimes provide avenues for avoiding taxation. One method of tax avoidance is treaty shopping which occurs when an entity, not intended as a recipient of tax treaty benefits, is able to structure its financial transactions in a way as to qualify for treaty benefits. See *supra* note 1 at 554.

five, I shall discuss the possibility of amending the LOB Article in the future to avoid some of its potential problems.

The central themes I shall advance in my thesis is to that the LOB Article, although it satisfies the United States' policy of preventing treaty shopping, is actually inefficient and inequitable as it has burdensome and complex compliance requirements and it violates basic tax treaty policy. I shall argue that the LOB Article is inefficient because its negative impact on Canadian taxpayers and on the flow of cross-border trade and investment outweighs any of its potential benefits, and there are other viable alternatives that could be implemented. Further, the LOB Article will not function efficiently as it is complex, vague and microregulatory. It is also questionable whether the minimal amount of treaty shopping that occurs between Canada and the U.S. justifies the inclusion of such a complex anti-treaty shopping provision.

I shall bolster the central theme of my thesis by arguing that the LOB Article results in several inequities, some of which will have severe economic consequences for a variety of Canadian entities. Essentially, the LOB Article falls within the ambit of the law of unintended consequences because it will cause many Canadian entities, including those not engaged in treaty shopping, to lose their entitlement to treaty benefits that they previously enjoyed under the Convention.¹⁶ The loss of treaty benefits will have a burdensome impact on particular Canadian entities.¹⁷ These entities will be forced to restructure if they do business or invest in the U.S. and desire the continued receipt of treaty benefits. Additionally, in order to maintain treaty benefits Canadian entities will be required to observe complex compliance and record keeping requirements.

I conclude that the inclusion of the LOB Article in the Protocol was not based upon rational decision making but was politically and bureaucratically motivated by U.S. tax treaty negotiators' zeal to halt treaty shopping at all costs. The inclusion of the LOB

¹⁶ For example, foreign controlled corporations, highly leveraged private companies, trusts and corporations controlled by trusts with non-resident beneficiaries may become ineligible for Treaty benefits. Janice G. Russell, *The New Limitation on Benefits Article*, 43 Can. Tax J. 964, 982 (1995).

¹⁷ *Ibid.*

Article demonstrates the preoccupation of the U.S. policy of eliminating treaty shopping over the basic goal of international tax treaties, which is the facilitation of trade and investment through the removal of tax barriers to the free exchange of capital, goods and services. Canada should not have conceded to the inclusion of the LOB Article in the Protocol because its negative impact on certain Canadian entities and the Canadian economy will outweigh the Protocol's potential benefits. A tax treaty between Canada and the U.S. should foster cross-border business not hinder it.

TAX TREATIES AND TREATY SHOPPING

In order to understand the rationale behind the LOB Article, one must be familiar with tax treaty policy and treaty shopping. In this chapter, I shall briefly overview the goals of tax treaty policy. I shall then discuss the problem of treaty shopping and the traditional methods employed to prevent treaty shopping.

Tax Treaty Policy:

Participants in international business transactions are subject to taxation in every country with jurisdiction over that transaction. Taxing authorities derive this jurisdiction from one of three principles: the 'source principle,' the 'residence principle' and the 'citizenship principle.' The source principle permits a country to tax income earned from sources within its borders, regardless of whether the recipient is a resident of that country. The residence principle allows a country to tax any person that has a substantial connection with the country so as to qualify as a resident of that country. Any income that is paid to a resident is subject to tax under the residence principle.¹⁸ Finally, the citizenship principle allows a country to tax their citizen's world-wide income regardless of their current residence.¹⁹

A consequence of these jurisdiction principles is that two or more countries can have concurrent jurisdiction to tax the same income. This is commonly referred to as 'double taxation'. Double taxation occurs when a person is considered to be subject to

¹⁸ Under the U.S. Internal Revenue Code ("IRC") the U.S. has jurisdiction to tax the income of foreign persons that is "effectively connected" with the conduct of a trade or business in the United States. I.R.C. sections 871(b) & 882.

¹⁹ The U.S. is the only developed country that uses the citizenship principle. See *supra* note 1 at 556 and I.R.C. sections 1 & 11.

taxation in both states, or where a resident of one state has income derived in the other state that is taxable by that other state.²⁰

When money flows from a domestic to a foreign party, and the income received by the foreign party is outside the jurisdiction of the state, the state exercises its jurisdiction over the transaction by requiring the domestic party to withhold a certain amount from the foreign party. This amount is what is termed a "withholding tax"... The root of double taxation emanated from the fact that, upon one transaction, a withholding tax may be imposed by the payor's government and, at the same time, an income tax may be imposed by the recipient's government. ... This, in turn, creates a potential deterrent to foreign trade and transboundary transactions.²¹

Double taxation inhibits the free exchange of goods and services and the movement of capital and persons by creating a comparative disadvantage for firms trying to compete abroad. In order to alleviate this disadvantage, and in order to attract foreign business, countries have entered into bilateral income tax treaties that ameliorate the negative effects of double taxation.

Bilateral tax treaties are contractual agreements between states that establish rules for when a state will relinquish to another state its taxing jurisdiction and its rights to tax certain revenue.²² Tax treaties can encourage the international flow of investment capital. A treaty can ensure that a source country will not excessively tax income derived from investments because the country where the investor resides will fully tax that income.²³ By reducing source income taxation a tax treaty can remove significant disincentives for investors to engage in cross-border trade and investment.

Income tax treaties have existed for almost a century. The first tax treaty was signed by Austria-Hungary and Prussia on June 21, 1899.²⁴ The first model bilateral tax treaty was developed by the League of Nations Committee of Technical Experts on

²⁰ Martha O'Brien, *International Corporate Structures and the New Protocol to the Canada-U.S. Income Tax Convention*, 54 *The Advocate* 43 (1996).

²¹ *The Queen v. Crown Forest Industries Limited*, 95 D.T.C. 5389 (S.C.C.), at 5396-7.

²² Frith Crandall, *The Termination of the United States-Netherlands Antilles Tax Treaty: What Were the Costs of Ending Treaty Shopping?*, 9 *Northwestern J. of Int'l L. and Business* 355, 362 (1988).

²³ *Ibid.*

²⁴ See *supra* note 3 at 167.

Double Taxation and Tax Evasion in 1927.²⁵ The first “modern” model treaty was produced by the Organization for Economic Co-operation and Development (“OECD”) in 1963.²⁶ The final draft of this treaty was adopted in 1977 and is referred to as the “1977 Model Convention.” Several countries have adopted its 30 Articles. In 1992, the OECD adopted its new Model Convention, which has also been widely accepted. Canada’s first tax treaty was the Canada–U.S. Income Tax Convention (1941). To date Canada has concluded bilateral tax treaties with more than 60 countries.²⁷ All these aforementioned

²⁵ *Ibid.* League of Nations Doc. C.216 M.85 1927 II (1927).

²⁶ Ross D. Tunnicliffe, *Topics in International Taxation*, UBC Law 410–1; International Taxation Course Material, 375 (UBC Faculty of Law, Spring 1996).

²⁷ Brian J. Arnold, *The Relationship between Tax Treaties and the Income Tax Act: Cherry Picking*, 43 Canadian Tax J. 869, 875 (1995). Tunnicliffe, *See supra* note 26 at 375, and CCH report that Canada has negotiated and signed tax treaties with the following countries. The Department of Finance is also negotiating new agreements with Chile, Columbia, Kazakhstan, Lithuania, Mauritius, South Africa, Ukraine, Venezuela and Vietnam. Canadian Income Tax Act with Regulations 65th Ed. 1817 (CCH 1995). Countries marked with an asterix have negotiated a treaty with Canada, but the treaties have not ratified as of July 28, 1995.

1. Argentina	16. France	34. Latvia*	49. Philippines	63. Turkey
2. Australia	17. Greece	35. Liberia*	50. Poland	64. United Kingdom
3. Austria	18. Germany	36. Luxembourg	51. Portugal	65. U.S.S.R/Russian Federation
4. Bangladesh	19. Grenada	37. Malaysia	52. Republic of Korea	66. United States
5. Barbados	20. Guyana	38. Malta	53. Romania	67. West Germany
6. Belgium	21. Hungary	39. Mexico*	54. Singapore	68. Yugoslavia
7. Brazil	22. India	40. Morocco	55. Spain	69. Zambia
8. Cameroon	23. Indonesia	41. Netherlands	56. Sri Lanka	70. Zimbabwe
9. Czechoslovakia*	24. Ireland	42. Netherlands/Antilles	57. Sweden	
10. Cyprus	25. Israel	43. New Zealand	58. Switzerland	
11. Denmark	26. Italy	44. Nigeria*	59. Tanzania	
12. Dominican Republic	27. Ivory Coast	45. Norway	60. Thailand	
13. Egypt	28. Jamaica	46. Pakistan	61. Trinidad & Tobago	
14. Estonia*	29. Japan	47. Papua New Guinea	62. Tunisia	
15. Finland	30. Kenya	48. People’s Republic of China		
	31. Korea			
	32. Kuwait			
	33. Windward Islands			

treaties have a central objective: the encouragement of trade by the prevention of double taxation of the same taxpayer in respect of the same income.

Tax treaties are designed to accomplish two goals: the elimination of double taxation; and the eradication of tax avoidance and evasion. ‘The principle function of income tax treaties is to facilitate international trade and investment by removing – or preventing the erection of – tax barriers to the free international exchange of goods and services and the free international movement of capital and persons...[T]he contribution which treaty commitments make to minimizing international trade and investment barriers... [is] a primary consideration in framing treaty provisions.’²⁸ It is in the best interests of nations to enter into income tax treaties, for this allows them to protect their source of income and to preserve a hospitable environment for desired inbound investment and trade.²⁹

Tax treaties seek to facilitate international trade and investment through several mechanisms. First, income tax treaties are designed to avoid double taxation.³⁰ To eliminate double taxation, tax treaties allocate taxing jurisdiction between the residence and the source countries in order to diminish overlapping jurisdiction.³¹ Usually, the residence country relinquishes jurisdiction to the source country and allows it to tax the income first. This can be accomplished through a pivotal provision included in most tax treaties; the tie-breaker rule, which ensures that a taxpayer is resident and therefore taxable on their worldwide in only one of the contracting states.³² Nonetheless, it has been well established that tax treaties do not impose taxes.³³ Tax treaties do not themselves levy taxes but simply authorize the contracting parties, within the terms of the

²⁸ See *supra* note 11 at 4.

²⁹ *Ibid.* at 2.

³⁰ *Ibid.* at 5.

³¹ See *supra* note 1 at 557.

³² See *supra* note 20 at 43.

³³ See *supra* note 26 at 875.

agreement, to do so.³⁴ Second, tax treaties serve to mitigate taxation which is not duplicative but is considered to be so burdensome that it may constitute a barrier to international trade or investment.³⁵ The most common application of this principle is found in treaty provisions which reduce or eliminate withholding taxes on investment income such as dividends, interest and royalties.³⁶ Third, tax treaties contain provisions prohibiting discrimination against residents of another country because taxation that discriminates against foreign residents has a negative effect on international transactions.³⁷ Finally, tax treaties have a role in facilitating tax administration. They are designed to assist tax administrators in dealing with: problems associated with international income flows; taxpayers that are located outside their taxing jurisdiction by providing for the collection and sharing of information; and for assistance in preventing unentitled third-country residents from obtaining treaty benefits.³⁸

Existing tax treaty principles hold that a source country may not discriminate against inbound direct investments as compared with domestically-owned investments, and it may not exceed low reciprocal withholding tax rates on returns on inbound portfolio investments and on subsidiary-to-parent flows.³⁹ These dual principles of nondiscrimination and reciprocity, along with home country relief from double taxation through an exemption of foreign source income or a foreign tax credit, are the ground rules for the international division of revenue from cross-border investment.⁴⁰

³⁴ *The Queen v. Melford Developments Inc.*, 82 DTC 6281, 6285; [1982] CTC 330, 335 (SCC), cited in note 33 at 870.

³⁵ See *supra* note 11 at 9.

³⁶ *Ibid.* at 9.

³⁷ *Ibid.* at 11.

³⁸ *Ibid.* at 11-12.

³⁹ See *supra* note 6 at 676.

⁴⁰ *Ibid.*

Treaty Shopping and Tax Havens:

While tax treaties are effective in achieving the goal of avoiding burdensome and double taxation, they do provide avenues for tax avoidance and tax evasion⁴¹ through the device of treaty shopping.⁴² The specificity and complexity of bilateral tax treaties creates the potential for loopholes and creative tax planning.⁴³ Residents of countries that are not party to a treaty may be able to use a tax treaty to reduce their tax liability.⁴⁴ 'Treaty shopping' occurs when a taxpayer shops into the benefits of a tax treaty that are normally not available, usually by interposing a corporation in a country that has an advantageous tax treaty.⁴⁵ The term treaty shopping is usually used by those opposed to this process, others refer to the process as "international tax planning".⁴⁶ It is the process by which taxpayers from one country search for and then attempt to receive the tax benefits provided by a tax treaty that their country of residence is not a contracting party. For example, when one country has a high withholding on certain transactions, to avoid the withholding tax the transaction is conducted through a related entity in a country that has no, or a lesser, withholding taxes.⁴⁷ The U.S. Senate Foreign Relations Committee, which reviewed the Third Protocol, defined treaty shopping as:

⁴¹ Tax evasion "occur[s] when non-compliance with the laws of the taxing jurisdiction is ... willful and conscious." See *supra* note 1 at 560. International tax evasion involves: 1) an element of artificiality so that the various business arrangements do not have business or economic aims as their primary objective; 2) an element of secrecy present in the transaction itself to prevent the taxing authorities from learning about the new scheme; and 3) the use of loopholes in the law or the application of legal provisions for purposes that they were not intended. *Ibid*.

⁴² The concept of 'treaty shopping' originated in the United States, and has been exported to other OECD countries. Helmut Becker and Felix J. Wurm, Survey, Treaty Shopping 1 (Helmut Becker & Felix J. Wurm eds., 1988).

⁴³ See *supra* note 22 at 362.

⁴⁴ *Ibid*.

⁴⁵ See *supra* note 42 at 1. Grady defines treaty shopping as the practice of third country residents searching for a country that has a favourable income tax treaty with the U.S. and an attractive internal tax law. When this country is located, income from the U.S. is channeled through a corporation organized under the laws of that country. By redirecting the income flow the withholding tax on the U.S. source passive income is thus reduced or completely eliminated. Additionally, many tax treaty countries have domestic tax laws that set a low, or possibly a zero, tax rate on passive income paid to non-residents. Kenneth A. Grady, *Income Tax Treaty Shopping*, 5 Northwestern J. of Int'l L. and Business. 626, 627-28 (1983).

⁴⁶ Roberta R. Oliva, *Recent Protocols to Tax Treaties Indicate Changes to International Tax Policy*, 10 The Int'l Tax J. 427, note 1 (1984).

⁴⁷ A.B. McKie, *Stopping Treaty Shopping*, 5 Canadian Current Tax 35 (January 1995).

[When] a person who is not a resident of either country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the non-resident is able indirectly to secure these benefits by establishing a corporation (or other entity) in one of the countries. Such an entity, as a resident of that country, is entitled to the benefits of the treaty without such safeguards. Additionally, it may be possible for the third-country resident to reduce the income tax base of the treaty-country resident by having the latter pay out interest, royalties, or other amounts under favorable conditions (i.e., it may be possible to reduce or eliminate taxes of the resident company by distributing its earnings through deductible payments or by avoiding withholding taxes on the distributions) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.⁴⁸

Treaty shopping can have several adverse effects. A treaty country can lose revenue when an investor whose country is not a treaty partner takes advantage of a tax treaty concession, such a reduction in withholding taxes, and the treaty country is not provided with a corresponding benefit from the investor's country.⁴⁹ Additionally, a country can lose revenue when its residents acquire investment earnings abroad and utilize a tax treaty to avoid paying domestic taxes.⁵⁰

The rise in corporate and personal income tax rates has encouraged many Canadians to use tax havens jurisdictions in conjunction with treaty shopping to reduce their exposure to Canadian taxation.⁵¹ A tax haven is a jurisdiction that imposes little or no tax, which makes it an attractive location to carry on business. A corporation resident in a tax haven can be used for: manufacturing goods for export;⁵² marketing goods for resale; licensing patents, trademarks and other intangible property to other foreign affiliates of the parent; providing financial services to other foreign affiliates of the parent;

⁴⁸ U.S. Senate Foreign Relations Committee Report on the Revised Protocol Amending 1980 U.S.-Canada Income Tax Convention (Exec. Rept. 104-9) (Doc 95-8159) 95 Tax Notes International 169-8 (Aug. 31, 1995).

⁴⁹ See *supra* note 22 at 363.

⁵⁰ *Ibid.* at 363-64.

⁵¹ Michael J. O'Keefe, *Tax Havens*, 53 The Advocate 209 (1995).

⁵² Income earned from manufacturing or marketing is active business income by virtue of the level of activity involved. Income earned from licensing or financing must fall within the deeming provisions in section 95(2)(a)(ii) of the Income Tax Act ("ITA") to be active business income. See *supra* note 51 at 209 footnote 11.

and carrying on investment businesses.⁵³ Tunncliffe has identified six generic off-shore structures that can effectively shelter corporate profits from Canadian tax. These structures are: off-shore finance corporations; off-shore licensing corporations; off-shore manufacturing corporations; off-shore trading corporations; off-shore investment business corporations; and off-shore service corporations.⁵⁴

For a tax haven to be beneficial to a corporation it must satisfy eight criteria. First, a haven must be in a 'designated treaty country.'⁵⁵ Canadian rules governing the taxation of foreign of persons provide that income earned by a foreign affiliate resident in a designated treaty country from an active business carried on in that designated treaty country may be repatriated to Canada by Canadian corporate shareholders without any

⁵³ These activities are undertaken in the tax haven so that the income generated will be income from an active business, and therefore not subject to Canadian taxation as they will be outside the foreign property accrual rules of the ITA. When a Canadian resident owns 10 percent or more of a foreign resident corporation, the corporation is known as a 'foreign affiliate'. If the foreign affiliate is controlled by the taxpayer or a related group, or by the taxpayer and less than 5 other persons resident in Canada, the foreign affiliate is a 'controlled foreign affiliate'. Foreign accrual property income ("FAPI") is any income from property or from a non-active business (usually investment income), as well as certain taxable capital gains, and is subject to special rules. FAPI will be taxed in the hands of a Canadian shareholder in the year the income is received or earned by the controlled foreign affiliate. Income will be excluded from FAPI if it is from an active business. Such active business income can include, for example, a dividend from a corporation that is a foreign affiliate, or a taxable capital gain on property used or held for the purpose of earning income from an active business, or a taxable capital gain on shares of a foreign affiliate at least 90 percent of the assets of which constitute property held for the purpose of earning income from an active business. Under ITA section 113(1) foreign active business income can be received as a dividend by a Canadian resident corporation with no applicable Canadian tax as exempt surplus. However, any foreign taxes on the exempt surplus are not eligible for the foreign tax credit. Thus, in order to achieve a level of tax savings from using a tax haven it is necessary to locate as many of the qualifying activities as possible in the haven. See *supra* note 51 at 211-13.

⁵⁴ Ross D. Tunncliffe, *Low Taxing Jurisdictions*, UBC Law 410 International Tax Law Materials 44-49 (UBC Faculty of Law 1995).

⁵⁵ Canadian domestic tax law used to refer to listed and unlisted countries in Income Tax Regulation 5907(11). If a country was listed then corporate residents in that country could qualify for exempt surplus status. The idea was that corporations in listed countries were entitled to exempt surplus status since Canada had negotiated and finalized a tax treaty with these countries. However, some of the listed countries did not have a finalized tax treaty with Canada but were listed in anticipation of a treaty being finalized. This created ambiguities because residents of those countries obtained exempt surplus status although they were not entitled to it. Thus, Regulation 5907(11) was amended so that references to listed countries were replaced with designated treaty countries. A designated treaty country is a country that has a comprehensive tax treaty with Canada that has entered into force. Another concern under prior Regulation 5907(11) was that eight 'listed countries' were also tax havens, which were entitled to exempt surplus status. These countries were: Anguilla; Antigua; Barbados; Cyprus; Ireland; Malaysia; Malta and Portugal. This was problem was partially solved under the amended Regulation 5907(11) as the substitution of 'listed country' with 'designated treaty country' eliminates Antigua, Anguilla, and Portugal from the list of non-treaty tax havens entitled to exempt surplus status. These countries do not have a comprehensive treaty with Canada, and thus no longer qualify as tax havens whose resident corporations are entitled to exempt surplus status.

additional Canadian income tax.⁵⁶ A designated treaty country is any country that has entered into a bilateral income tax treaty with Canada. Since Canada has entered into few tax treaties with tax havens, there are few designated treaty countries that offer a favorable tax rate.⁵⁷ Second, while the location of a tax haven does not have to be where the corporation carries out its day to day operations, the haven should be a place where some corporate activities take place and there is reasonable access to and from Canada.⁵⁸ Third, a tax haven must have a developed infrastructure.⁵⁹ Fourth, the haven must not have any monetary exchange controls that would limit the ability to repatriate funds in the future. Fifth, the ability to transact business in English is usually considered essential. Sixth, a legal system based on English common law creates a sense of familiarity and security, and is thus a desirable feature. Seventh, a well-developed treaty network is advantageous. This would be of great assistance if the foreign subsidiary's activities may expose it to tax in certain countries, even though it would not have a permanent establishment in those countries. Finally, a tax haven should have economic and political stability.⁶⁰

⁵⁶ Under subsection 113(1) of the ITA, a corporation resident in Canada may deduct from its taxable income dividends received from a foreign affiliate that are prescribed under Regulation 5900(1) to have been paid out of the exempt surplus of the foreign affiliate. In order for the foreign corporation paying the dividends to qualify as a 'foreign affiliate' the Canadian corporation must have a direct or indirect interest of a minimum of 10 percent of the shares of the foreign corporation. ITA sections 95(1), 95(4)(a), (b). If the foreign subsidiary is not resident in a designated treaty country or its business is not carried on in a designated treaty country, then the dividends paid by the foreign subsidiary to the Canadian parent corporation are subject to tax in Canada at ordinary corporate tax rates with an offsetting deduction for income and withholding taxes paid by the subsidiary. If the subsidiary is resident in a tax haven jurisdiction that is not a designated treaty country, then the dividends are effectively taxed in Canada at full corporate tax rates regardless of the source of the subsidiary's income. One exemption is where dividends are received by a subsidiary from another foreign affiliate of the parent that are paid out of that foreign affiliate's exempt surplus. These dividends are included in the exempt surplus of the subsidiary, regardless of where it is resident, and can be paid to the parent without attracting Canadian taxation. *See supra* note 51 at 209.

⁵⁷ One exception, however, is Barbados.

⁵⁸ Reasonable access would be access by scheduled airline flights of a reasonable duration and if goods are shipped from the tax haven then there must be appropriate shipping routes. *Ibid.* at 210.

⁵⁹ The tax haven country must have the ability to receive and store goods, proper banking facilities, the availability of adequate clerical personnel and skilled labour, and access to suitable manufacturing facilities. *Ibid.*

⁶⁰ Many Canadian corporations have selected Barbados as a tax haven because it meets the above criteria. Barbados is stable, has the second oldest parliament in the British Commonwealth, has a system of laws based on English common law, has a satisfactory infrastructure and ease of access to both North America and Europe. Other tax havens, although not as suitable as Barbados because they have language and logistical problems, are Portugal and the island of Madeira. Ireland can also be considered an acceptable tax haven, but it has a high corporate tax rate or 10 percent and requires a certain level of employment. Malta or Cyprus may be useful if the business involves Europe. Similarly, Luban (the federal territory of Malaysia) can be utilized if the activity involves Asia.

A substantial tax saving can be realized by the combined use of a tax haven jurisdiction, treaty shopping and advantageous transfer pricing. However, it should be noted that the residency requirements in several of the tax treaties Canada has with tax havens provide that there will be *no* treaty assistance to corporations that are incorporated under legislation that exempts the corporation from taxation in the tax haven country.⁶¹

A. Treaty Shopping Methods:

There are three ways in which treaty shopping can occur. These are the 'direct conduit' method, the 'stepping stone' method and the 'bilateral relations' method.

i. Direct Conduit Method:

Under the direct conduit method,⁶² countries A and B, for example, enter into a tax treaty that allocates taxing jurisdiction over dividend payments by corporations in

However, it should be noted that in the case of Barbados, for most purposes it is not a tax haven because it levies taxes at fairly high rates. But there is provision, however, for a special status corporation, the international business company (IBC), which is subject to a maximum tax rate of 2.5 percent. Further, when an IBC pays dividends to a foreign parent Barbados does not levy withholding taxes and most importantly, if paid from exempt surplus, dividends are not taxed when received by a Canadian corporation. Other than the maximum 2.5 percent tax rate, IBCs are exempt from taxation under Barbados law and they are not subject to tax on rents (other than from Barbados property), dividends, interest, royalties, fees, salaries or other money paid by the IBC to a company carrying on international business or to a person resident outside the Barbados. A corporation will qualify as an IBC if it is resident in Barbados, owned by persons not resident in Barbados or the other Caribbean states (the 'CARICOM' region), financed by persons not resident in the CARICOM region and carries on an international manufacturing business or an international trade and commerce business. (See the Barbados International Business Corporations Act 1991). An IBC may carry on the business of manufacturing goods in Barbados for sale outside the CARICOM region or buying and selling goods to be trans-shipped through or from Barbados and may sell services for the benefit of person residing outside the CARICOM region. IBC status extends to corporations engaged in making, processing, preparing, assembling or packaging within Barbados any product that is exclusively for export to countries outside the CARICOM region. IBCs also receive duty-free exemptions on imports of plant, machinery, equipment, raw materials and components used in manufacturing. Further, IBCs engaged in international trade or manufacturing are granted automatic exemptions from foreign exchange controls. Of course, an IBC must be resident in Barbados, which requires incorporation in Barbados. However, it is necessary to ensure that the corporation is also not resident in Canada for Canadian income tax purposes. *Ibid.* 210-12.

⁶¹ See the Agreement between Canada and Barbados for the Avoidance of Double Taxation and the prevention of Evasion with Respect to Taxes on Income and on Capital, January 22, 1980; The Treaty between Canada and the Republic of Cyprus for the Avoidance of Double Taxation and the prevention of Fiscal Evasion with respect to Taxes on Income and on Capital, May 2, 1984; and the Agreement between Canada and the Republic of Malta of the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, July 25, 1986. Article XXX of the Canada-Barbados Treaty provides that the Treaty shall not apply to corporations entitled to any special tax benefits under the Barbados International Business Corporations Act.

⁶² See *supra* note 1 at 560. The direct conduit situation is the typical case of concern to the IRS. See *supra* note 42 at 289.

country A to shareholders in country B. A corporation in country C owns a subsidiary in country A, however country C does not have tax treaties with either states A or B. In order to take advantage of the A-B tax treaty, the parent corporation in country C sets up wholly-owned subsidiary in country B and transfers all of its shares in the country A subsidiary to the country B subsidiary. When the country B subsidiary receives dividend income from the country A subsidiary, it claims a full or partial exemption from the withholding taxes of country B pursuant to the A-B tax treaty. The subsidiary consequently pays little or no taxes on the income it receives. This income is then transferred back to the parent corporation as a fictitious loan.⁶³

⁶³ See *supra* note 1 at 561 and note 42 at 4.

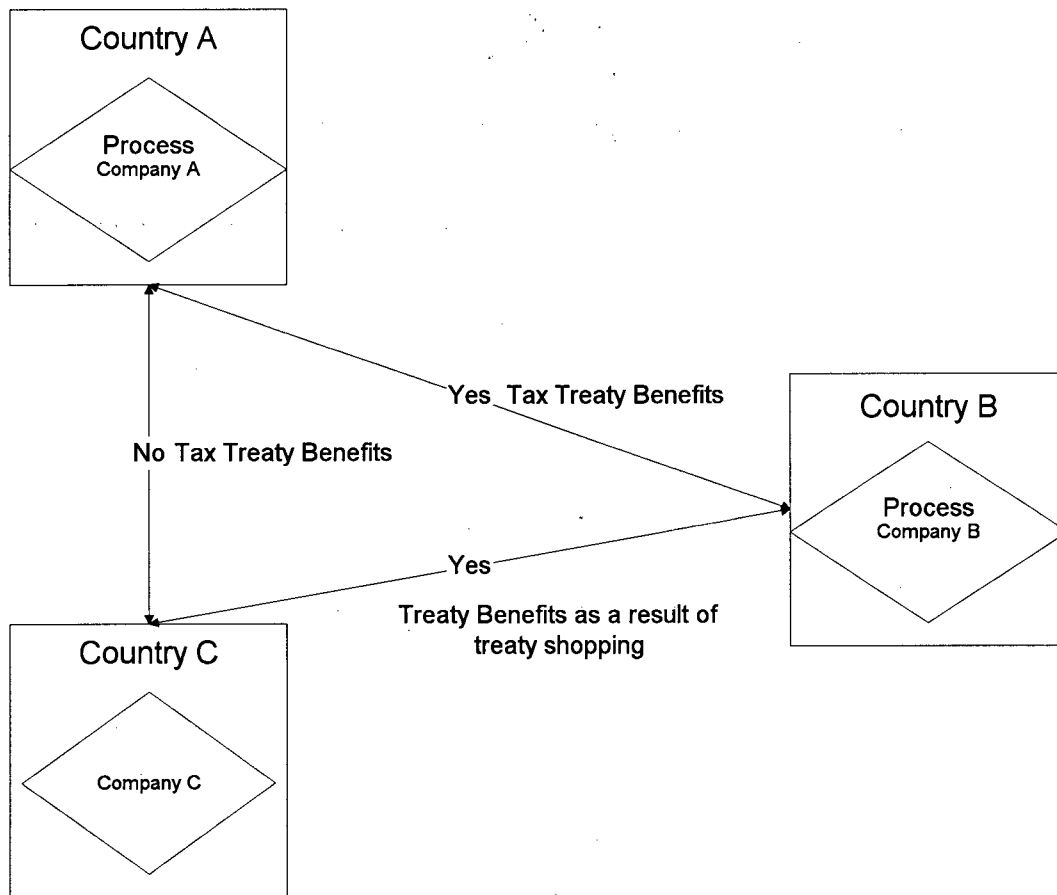


Figure 1: The Direct Conduit Method of Treaty Shopping⁶⁴

ii. The Stepping Stone Method:

The stepping stone method of treaty shopping occurs, for example, where country A does not have a tax treaty with country C, but does have a tax treaty with country D and country D applies favorable tax treatment to certain types of companies. In country B, charges from a foreign company are tax deductible and income from country C is subject to treaty benefits. Residents of country A set up a company in country D that derives most of its profits by providing services to its subsidiary in country B. The company in country B realizes income in country C where it is subject to beneficial tax

⁶⁴ This diagram is adapted from note 42 at 16.

treaty treatment. The profits from country C are channeled to country D at almost no cost. Since the profits are subject to low or no taxation in country D, the income from country C arrives in country A at little or no tax cost.⁶⁵

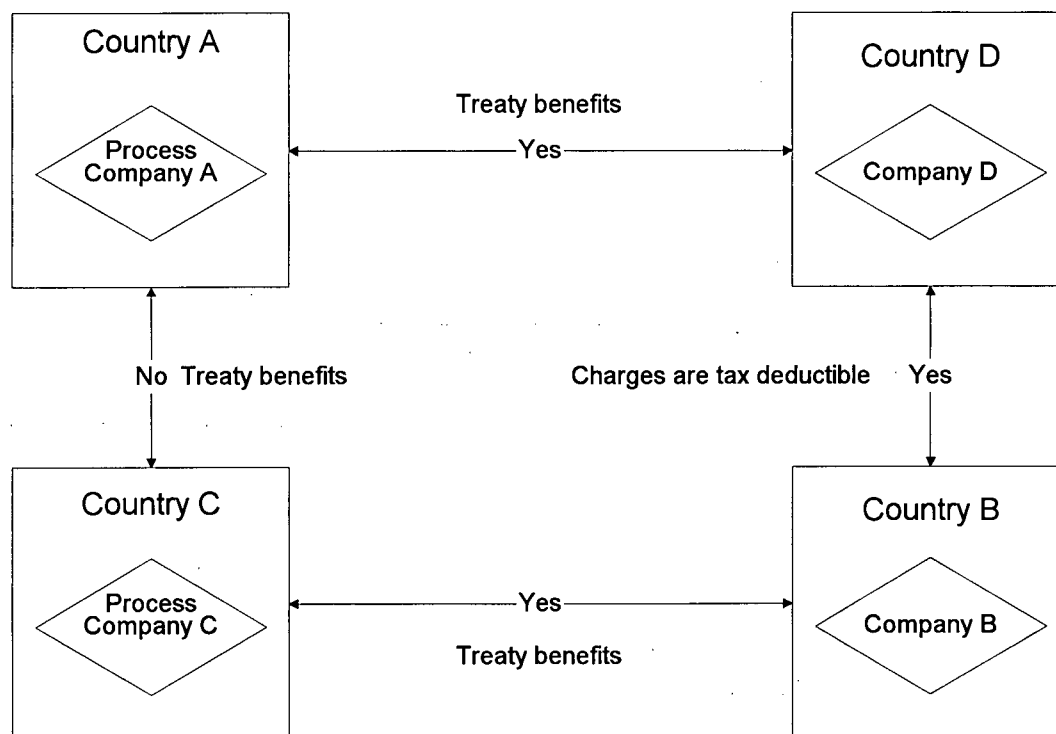


Figure 2: The Stepping Stone Method of Treaty Shopping⁶⁶

iii. The Bilateral Relations Method:

The bilateral relations method of treaty shopping is subdivided into two types: the *same country holding structure* and the *quintet structure*. The same country holding structure occurs where tax treaties grant treaty benefits to shareholders with minority ownership and national tax laws subject dividends to low taxation if they are received by another company in the same country. A foreign investor can interpose a company in that state that holds the participation in the other company where the final investment is made.

⁶⁵ *Ibid.* at 4, 5.

⁶⁶ This diagram is adapted from *Ibid.* at 17.

Under such a structure tax advantages may be gained for minority participation that otherwise would not be available.⁶⁷ This structure has not been considered to be treaty shopping in the U.S. and has never been challenged as such.⁶⁸

The quintet structure is designed to get reduced withholding rates on dividends from a payor organized in a state granting reductions only with respect to dividends paid to minority shareholders.⁶⁹ Where a tax treaty suspends treaty benefits on dividends that are received by a foreign company holding a certain percentage of the domestic company's shares, i.e. 25 percent, a foreign company can interpose 5 subsidiaries each holding less than 25 percent of the shares of the domestic corporation in order to benefit from the tax treaty.⁷⁰

⁶⁷ *Ibid.* at 5.

⁶⁸ *Ibid.* at 290.

⁶⁹ *Ibid.*

⁷⁰ *Ibid.* at 5.

Quintet Structure:

Same Country Holding
Structure

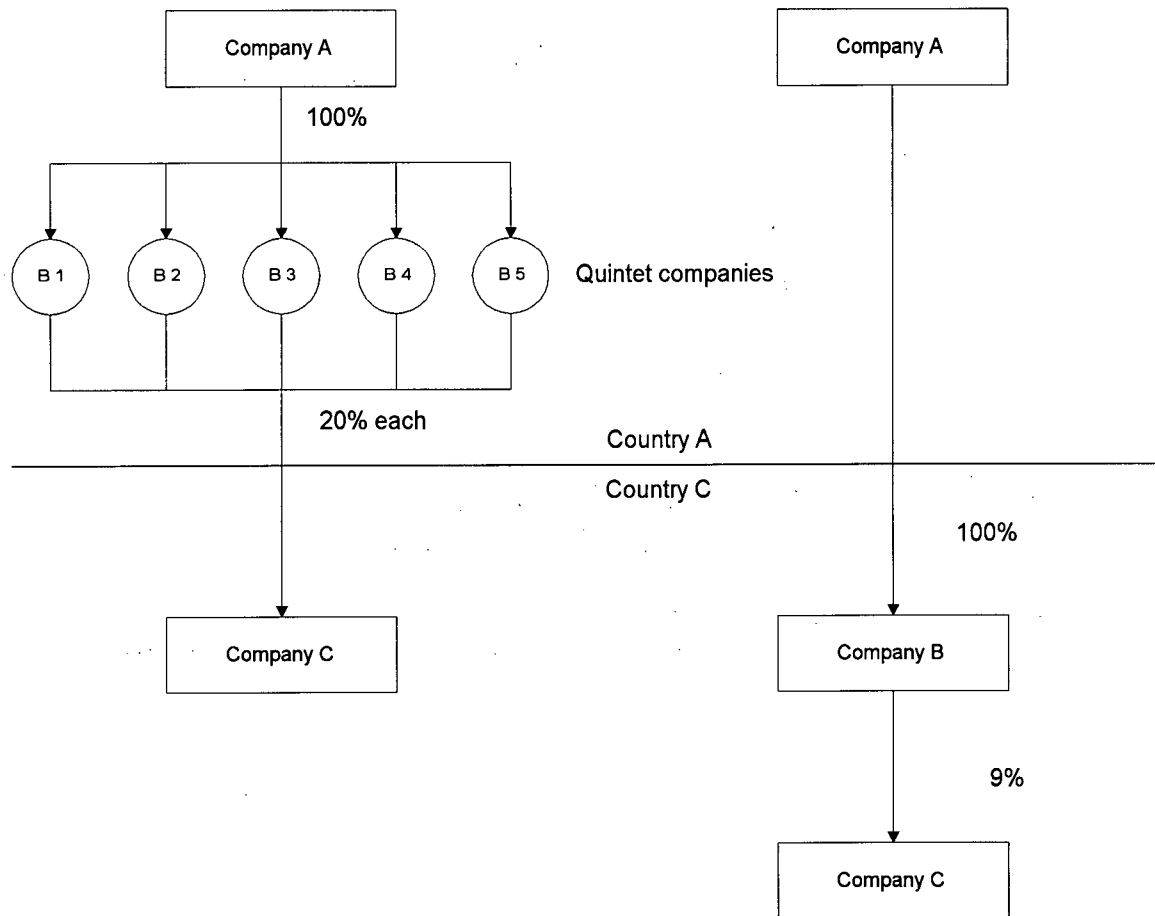


Figure 3: The Bilateral Relations Method of Treaty Shopping⁷¹

B. Countering Treaty Shopping:

i. The Objections to Treaty Shopping:

Tax authorities consider treaty shopping improper for three primary reasons.⁷² First, treaty benefits negotiated between two states are intended for persons resident in

⁷¹ This diagram is adapted from *Ibid.* at 18. The same country holding and the quintet structures are generally not considered to be treaty shopping by the IRS since U.S. tax treaties do not grant reduced withholding rates for minority participation.

⁷² *Ibid.* at 5.

those states. If a third country resident 'shops' into a treaty, the third country resident benefits from the treaty without its country of residence providing treaty considerations to any of the contracting parties. The principle of reciprocity is breached and the balance of sacrifices in the international tax treaty system is altered. Second, states usually grant treaty benefits to the resident of another country based on the assumption that the other country's residents are subject to the other country's tax regime. If treaty benefits are enjoyed by a person in a third country there is no guarantee that they will be subject to a satisfactory tax regime. Third, there is little incentive for a third country to enter into a tax treaty if its residents enjoy the use of other country's existing tax treaties.

ii. *Anti-Treaty Shopping Methods:*

International authorities have not reached a consensus as to when tax avoidance should be curtailed and by what means because of the difficulty in drawing a distinction between those arrangements that are acceptable and those that are not.⁷³ However, most countries accept that blatant tax evasion through treaty shopping should be halted. The primary method to combat such tax avoidance schemes is through the exchange of tax information between two contracting states. These provisions are a routine part of tax treaties as they are necessary to prevent fraud and tax evasion.⁷⁴ However, to be effective they must be combined with anti-treaty shopping provisions that restrict the availability of treaty benefits to intended parties only.⁷⁵ Several approaches have been developed to attempt to curb treaty shopping.⁷⁶

First, the *abstinence approach* dictates that countries should not enter into tax treaties with countries that are considered to be tax havens, either because of their low taxation or because they are used as a location for conduit companies. Second, under the *exclusion approach*, where a tax treaty exists between two states, companies entitled to

⁷³ See *supra* note 1 at 562.

⁷⁴ *Ibid.*

⁷⁵ *Ibid.* at 563.

⁷⁶ See *supra* note 42 at 6. The anti-treaty shopping approaches are endorsed by the U.N. and the OECD. See text accompanying notes 566 to 570.

special-low taxes are excluded from tax treaty benefits. Third, under the *look-through approach* treaty benefits are granted to a company only to the extent that it is owned by residents of the state in which it is organized. Entitlement to treaty benefits does not depend on the company's state of residence alone. Rather, the legal entity is disregarded and the residence of its shareholders is examined to determine whether or not the company should be granted treaty benefits, hence the name look-through approach. A refined version of this approach examines who the beneficial owners, rather than mere nominal shareholders, of the shares are. Fourth, under the *subject-to-tax approach* treaty benefits are subject to the condition that income derived from one state be actually subject to a minimum tax in the other state. This prevents income from being exempt from taxation in both contracting states.⁷⁷ Fifth, the *channel approach* is designed to attack the stepping-stone structure. Under this approach a company is denied treaty benefits on dividends, interest, and royalties, if a certain percentage of its gross income is used to make payments to individuals or companies not resident in one of the contracting states. This prevents the income of the interposed company from being absorbed by payments to related persons or companies in the form of business expenses. Finally, the *bona fide approach* guarantees that *bona fide* transactions and structures are not exempt from treaty benefits. The granting of treaty benefits depends upon the satisfaction of certain requirements, such as the motives of the interposing company, the amount of the company's business activity in the state, the amount of taxes paid, and the registration of its shares on a national stock exchange.⁷⁸

In addition to specific tax treaty provisions that combat treaty shopping, several countries also apply their general anti-tax avoidance or anti-abuse provisions to prevent treaty shopping.⁷⁹ There are typically two types of tax principles that can be applied;

⁷⁷ *Ibid.* at 6, 7. This is essentially the approach the Supreme Court of Canada adopted in *The Queen v. Crown Forest Industries Limited*, 95 D.T.C. 5389 (S.C.C.), when it denied treaty benefits, in the form of reduced withholding rates, to a U.S. corporation whose mind and management was located in the U.S. This was done on the basis that the corporation was not subject to taxation on its worldwide income in the U.S. See the discussion in note 517.

⁷⁸ *Ibid.* The *bona fide* approach is essentially the restrictive approach that U.S. anti-treaty shopping provisions utilize, such as the limitation on benefits provisions.

⁷⁹ *Ibid.* Switzerland and the United States also have specific anti-treaty shopping in their national laws. *Ibid.*

substance over form and the abuse principle.⁸⁰ Under the *substance over form* test, tax authorities must determine whether the transaction is based on justifiable commercial reasons or whether it is a sham merely set up to obtain treaty benefits. Under the *abuse principle* the issue is whether a certain set of transactions constitutes an abuse, a misuse or an improper use of a tax treaty.

One issue that arises when national laws are applied to combat treaty shopping is in the case of a conflict whether the tax treaty or the national tax law applies. Generally, where a treaty specifies who is entitled to treaty benefits, for example all residents including legal entities organized under the laws of that state, the clear wording of the treaty cannot be disregarded and treaty benefits cannot be denied on grounds that the entity's shareholders are not residents.⁸¹ Further, if the treaty includes a provision to prevent tax treaty abuse then national tax rules cannot be applied in addition to the treaty provisions.

iii. Costs of Stopping Treaty Shopping:

Although it has been argued, particularly by the U.S., that reducing or eliminating treaty shopping is crucial, it must be recognized that there are significant costs in accomplishing this goal. As economic theory has demonstrated, attempting to increase the accumulation of wealth results in diminishing returns. Similarly, the extension of anti-treaty shopping rules will result in diminishing returns and increased costs. Enlarging the scope of an anti-treaty shopping regime invariably results in increasing the number of detailed rules governing the taxation of international business transactions. The number and complexity of such micro-regulations makes it difficult for taxpayers to comply with such tax provisions.⁸² Further, these provisions may become so detailed and rigorous that they can deny relief to entities carrying *bona fide* commercial activity.⁸³ It has been

⁸⁰ *Ibid.*

⁸¹ *Ibid.* at 8.

⁸² See *supra* note 1 at 563.

⁸³ *Ibid.* The complexity of the LOB Article in the Protocol will cause several *bona fide* Canadian residents to lose treaty benefits.

argued that the complexity and restrictiveness of anti-treaty shopping provisions inhibit investment flows because would be investors fear that they may be denied relief under the treaty.⁸⁴ The very nature of these provisions introduces an element of uncertainty into the investment climate – the more rigorous the statute, the greater the chance that an entity will not fulfill the criteria required to obtain relief.⁸⁵ This uncertainty raises the cost of investment.⁸⁶ Consequently, Gild has concluded that strict anti-treaty shopping provisions could eliminate almost all incentives to foreign investment.⁸⁷

⁸⁴ *Ibid.* at 564. Gild refers to the LOB Article in the U.S.–West German Tax Treaty as an example of the growing complexity of anti-treaty shopping provisions. *Ibid.* at 563 note 47. The LOB provision in that treaty was developed in 1989. It is less complex and shorter than the LOB Article in the Protocol.

⁸⁵ *Ibid.* at 573.

⁸⁶ *Ibid.*

⁸⁷ *Ibid.* at 565.

THE THIRD PROTOCOL TO THE CANADA-U.S. TAX CONVENTION

On November 9, 1995, Canada and the United States ratified the Third Protocol⁸⁸ amending the 1980 Convention between Canada and the United States with respect to taxes on Income and on Capital Gain.⁸⁹ The majority of its provisions became effective on January 1, 1996. The Protocol significantly improves the present Convention as it eliminates many pre-existing tax barriers for cross-border trade and investment and it opens a new level of co-operation between Canadian and American tax authorities.⁹⁰ The principal purposes of the Protocol are to modify the Convention in order to continue to promote close economic co-operation between Canada and the U.S. This is done by reducing the occurrences of double taxation of income earned by residents of either country from sources within the other country and eliminating possible barriers to trade

⁸⁸ On March 17, 1995, a revised Protocol amending the Treaty Between Canada and the United States with Respect to Taxes on Income and on Capital signed on September 26, 1980, as amended by the Protocols signed on June 14, 1983 and March 28, 1984, was signed. The revised Protocol is essentially the same as the August 31, 1995, Protocol. The revised Protocol merely recognizes that the Protocol has not yet been ratified and it accordingly reflects with revised dates as to effectiveness of the Protocol. Department of Finance press release, March 17, 1995.

⁸⁹ The old Tax Treaty is the Convention between Canada and the United States of America with Respect to Taxes on Income and Capital, signed 26 September, 1980, as amended by Protocols signed 14 June, 1983, and 28 March, 1984.

⁹⁰ However, treaty negotiators failed to identify and deal with some situations that needed resolution. For, example the use of limited liability companies (LLCs) by U.S. individuals was not addressed by the Protocol. Using an LLC to carry on investment or business activities is inadvisable because while LLCs are regarded as corporations for Canadian tax purposes they are given flow-through treatment under U.S. tax law and as a result they are not considered residents under the Convention and thus are not entitled to treaty benefits and are subjected to the full Canadian withholding rate of 25 percent.

Also it is unfortunate that the negotiators did not deal with the problem of potential double taxation that arises from Revenue Canada's reluctance to view IRC section 884(f)(1)(B) (branch profit tax) excess interest tax as an additional tax on a U.S. branch of a Canadian corporation which would thus be credible against Canadian taxes on U.S. branch profits.

Further, negotiators did not deal with the problem of U.S. corporations that own Canadian operating subsidiaries through a partnership. If two U.S. corporations are in a 60-40 partnership, owning 100 percent of the Canadian subsidiary, dividends paid by the subsidiary to the partnership will not qualify for the reduced withholding rate but will be subject to a 15 percent rate. This is because Revenue Canada has determined that the U.S. corporate partner does not the property of the partnership, even though if the U.S. corporation held the subsidiary shares directly they would qualify for the reduced rate. *See supra* note 13.

caused by the overlapping taxing jurisdictions of the two countries.⁹¹ It is also intended to enable Canada and the U.S. to cooperate in preventing the avoidance and evasion of taxes. These amendments are designed to encourage trade and investment between Canada and the United States and thus the Protocol can be seen as a favorable complement to the North American Free Trade Agreement.⁹²

In this chapter I shall briefly review how the Protocol amends the Convention. These amendments can be divided into five parts. First, there are significant amendments to the withholding rates for dividends, branch profits, interest and royalties. Second, the Protocol amends the treatment of taxes imposed by reason of death. Third, there are changes to certain administrative provisions of the Convention are changed to allow greater co-operation between Canadian and American tax authorities. Under the Protocol, disputes between competent authorities can go to arbitration. There is also a new provision for assistance with tax collection and the exchange of information provisions have been expanded. Fourth, there are changes to several miscellaneous, but important, provisions, such as the definition of residence and the tax treatment of pensions and gambling losses. Finally, there is the addition of the LOB provision, the anti-treaty shopping rules, which could have severe and unanticipated effects for some Canadian residents. An in depth analysis of the operation and impact of the LOB provision is contained in the next chapter.

Amendments to the Convention:

A. Withholding Tax Provisions:

The Protocol reduces the withholding tax rate on interest, direct dividends and certain royalties. Under the *Income Tax Act*, ("ITA") where there is no tax treaty to the contrary, dividends, interest and certain royalties paid by Canadian residents to foreign

⁹¹ See *supra* note 48.

⁹² *Protocol to Canada-U.S. Tax Treaty Signed*, 380 Tax Notes 3 (September 14, 1994).

recipients are subject to a withholding tax of 25 percent.⁹³ In the U.S. the withholding tax rate is 30 percent. Under the Convention, prior to the Third Protocol, the 25 percent default withholding tax rate was reduced to 10 percent on 'direct dividends,'⁹⁴ 15 percent for other dividends, 15 percent for interest payments and 10 percent for certain royalty payments. Under the Protocol these withholding taxes are reduced. The withholding taxes on cross-border direct dividends and branch profits tax⁹⁵ will be eventually reduced to 5 percent.⁹⁶ The withholding tax on cross-border interest is reduced to 10 percent from the current 15 percent.⁹⁷ Finally, the withholding taxes on royalties for the use of computer software or any patent or information concerning industrial, commercial or scientific experience are eliminated. The Protocol provides for consultation within three years to determine if these withholding taxes should be further reduced.⁹⁸

The reduction of these withholding rates is significant. Canadian Finance Minister Paul Martin indicated that the reduced rates under the Treaty will facilitate trade and investment between Canada and the United States.⁹⁹ The Minister emphasized that the elimination of withholding taxes on royalties for patent and technological information and computer software payments will reduce the cost to Canadian companies of imported technology and know-how from the United States and it should make Canadian technology more attractive to U.S. businesses.¹⁰⁰ However, what the Finance Minister

⁹³ Joe Frankovic, *Changes to the Canada-U.S. Tax Treaty-Highlights*, 382 Tax Notes 4 (October 18, 1995).

⁹⁴ A direct dividend is a dividend paid to a non-resident corporate shareholder owning at least 10 percent of the voting shares of the corporation.

⁹⁵ A domestic tax imposed on uninvested earnings of a branch of a foreign corporation, meant to be equivalent to a dividend withholding tax.

⁹⁶ The reduced rates are phased in gradually. Effective January 1, 1996, the withholding tax rate will be reduced to 6 percent and eventually in the subsequent following year the rate will be reduced to 5 percent.

⁹⁷ The withholding tax rates may be reduced in future as the Protocol allows for consultation to determine if withholding taxes should be reduced further.

⁹⁸ See Appendix One; Third Protocol, Article 20 paragraph 1.

⁹⁹ Department of Finance Press Release, August 31, 1994. The majority of the Treaty's provisions will become effective on January 1, 1996.

¹⁰⁰ Finance Minister Martin indicated that the reduction of the rate of withholding tax on interest, direct dividends and certain royalties to 10 per cent, 5 per cent and 0 per cent respectively bring these rates into line with those provided in the OECD Model Tax Convention and accepted by a majority of the 25 Member countries of that organization. *Ibid.*

failed to mention was that the reduction of withholding taxes will result in a reduction of Canadian tax revenues. Using 1974 data Jenkins et al, estimated that reducing the withholding tax from 15 percent to 10 percent would reduce Canada's tax revenue by \$57 million.¹⁰¹ Although I have not come across any more recent figures on the decrease in Canadian tax revenues as a result of decreasing withholding taxes, it can be extrapolated from the 1974 estimates that in 1996 the reduction in tax revenues will be even greater. The Protocol may have a significant effect on Canadian tax revenues particularly when the impact of the LOB Article on tax revenues is considered.¹⁰² What this impact will be is currently unknown, but the next few years will be telling as to how much tax revenue has sifted from Canada to the U.S.

These changes to the withholding rates were necessary as the Convention was negotiated in the early 1980's and was out of step with the current policy of facilitating the free flow of goods and services.¹⁰³ Prior to the Protocol, the Convention perpetuated trade barriers through high withholding rates on a wide range of intellectual property rights and computer software payments. Technology goods could flow duty free as a result of NAFTA but the technology, if transferred alone, remained subject to a 10 percent withholding tax.¹⁰⁴ The fact that finished goods, such as shrink wrapped software, could flow free of withholding tax, while the transfer of technology could not, influenced commercial behavior.¹⁰⁵ A U.S. company could avoid the withholding tax by shipping finished goods to its Canadian subsidiary instead of licensing the technology that would be subject to a 10 percent withholding tax. Additionally, the free flow of financial services could not be fully achieved as long as interest payments were subject to a 15 percent withholding tax.¹⁰⁶

¹⁰¹ Glen P. Jenkins, Devendranauth Misir and Graham Glenday, *The Taxation of Foreign Investment Income in Canada, the United States and Mexico*, 44 Law and Contemporary Problems 156 (1981).

¹⁰² See text following note 197.

¹⁰³ Catherine A. Brown, *The 1995 Canada-U.S. Protocol: The Scope of the New Royalty Provisions*, 43 Canadian Tax J. 592, 593 (1995).

¹⁰⁴ *Ibid.*

¹⁰⁵ *Ibid.* at 594.

¹⁰⁶ *Ibid.* at 593.

Figure 4: Summary of Changes to the Withholding Rates under the Protocol.¹⁰⁷

	PRE-PROTOCOL	01/1996	01/1997
DIVIDENDS			
1. Direct	10%	6%	5%
2. Portfolio	15%	15%	15%
BRANCH PROFITS	10%	6%	5%
INTEREST	15%	10%	10%
ROYALTIES	10%	0% or 10%	0% or 10%

i. Dividends:

Article 5 of the Protocol amends Article X (Dividends) of the Convention, it reduces the withholding rate on ‘connected’ dividends from 10 percent to 5 percent.¹⁰⁸ The rate of branch profits tax under paragraph 6 is also reduced from 10 percent to 5 percent.¹⁰⁹ Under the entry-into-force provisions of Article 21 of the Protocol, these

¹⁰⁷ This graph is adopted from O’Brien, *see supra* note 20 at 44.

¹⁰⁸ *See* Appendix One; Third Protocol, Article 5. Paragraph 1 of Article 5 amends paragraph 2(a) of Article X. Connected dividends are dividends paid to a company resident in the other Contracting State that owns at least 10 percent of the voting stock of the company paying the dividends and that is the beneficial owner of the dividend.

¹⁰⁹ *Ibid.*

reductions will be phased in over a three-year period. The rates will be 6 percent in 1996 and finally 5 percent in 1997.

For Canadian Multinationals operating in the U.S. through subsidiaries, the reduction in dividend withholding is equivalent to approximately three percentage points of U.S. subsidiary profits before U.S. income taxes, assuming a 40 percent aggregate U.S. federal and state corporation tax rate.¹¹⁰ This reduction directly effects the bottom line as a result of the exempt status of such dividends and the lack of a foreign tax credit for U.S. taxes under Canadian foreign affiliate exempt surplus rules.¹¹¹

Nevertheless, the 5 percent withholding rate will be inapplicable in certain situations. Dividends paid by U.S. regulated investment companies ("RICs")¹¹² are denied the 5 percent withholding rate even if the Canadian shareholder is a corporation that would otherwise qualify as a direct investor by satisfying the 10-percent ownership requirement. Consequently, all RIC dividends to Canadian beneficial owners are subjected to the 15 percent rate that applies to dividends paid to portfolio investors.¹¹³ Similarly, Dividends paid by U.S. real estate investment trusts ("REITs")¹¹⁴ to Canadian beneficial owners are also denied the 5 percent rate. REIT dividends paid to individuals who own less than a 10 percent interest in the REIT are subject to withholding at a rate of 15

¹¹⁰ See *supra* note 13.

¹¹¹ *Ibid.*

¹¹² Companies subject to IRC sections 851-855, Alexander M. G. Gelardi, *The New Protocol to the Canada-United States Treaty: A Major Document*, 21 *The Int'l Tax J.* 54, 55 (1995).

¹¹³ United States 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 signed at Washington on September 26, 1980, as amended by the Protocols signed on June 14, 1983 and March 28, 1984 (hereinafter the "Technical Explanation").

While it is not customary in Canada to issue a technical explanation on tax treaties concluded by Canada, Finance Minister Paul Martin indicated that Canada agrees that the technical explanation accurately reflects understandings reached in the course of negotiations with respect to the interpretation and application of the various provisions in the Protocol of March 17, 1995. Department of Finance press Release, June 13, 1995.

¹¹⁴ Companies subject to IRC sections 856-859, see *supra* Gelardi note 112 at 55 note 8.

percent. REIT dividends paid to other Canadian beneficial owners are subject to the standard 30 percent withholding rate.¹¹⁵

The denial of the 5 percent withholding rate to all RIC and REIT shareholders, and the denial of the 15 percent rate to REIT shareholders who own beneficially own more than 10 percent of the REIT is intended to prevent the use of these non-taxable conduit entities to gain unjustifiable benefits for certain shareholders.¹¹⁶ In the absence of special, the interposition of a RIC would transform what should be portfolio dividends into direct investment dividends taxable at source by the United States only at 5 percent, the special rules prevent this.¹¹⁷ A resident of Canada may hold U.S. real property directly and pay U.S. tax either at a 30 percent rate on the gross income or at the income tax rates specified in the Internal Revenue Code ("IRC") on the net income. By placing the real estate holding in a REIT, the Canadian investor could transform real estate income into dividend income and thus transform high-taxed income into much lower-taxed income. In the absence of the special rules, a REIT shareholder that is a Canadian corporation would be subject to a withholding rate of 5 percent or 15 percent; depending on the level of shareholding, and the standard withholding rate of 30 percent or more would be significantly reduced.¹¹⁸

There is also a special rule for certain dividends paid by Canadian non-resident-owned investment corporations ("NROs").¹¹⁹ This provides a maximum rate of 10

¹¹⁵ See *supra* note 113, Technical Explanation, Article 5. This also applies to REIT dividends received by an estate or testamentary trust for a period of five years following death because the estate or trust is regarded an individual for the five year period. See *supra* Gelardi note 112 at 55.

¹¹⁶ See *supra* note 113, Technical Explanation, Article 5.

¹¹⁷ *Ibid.*

¹¹⁸ *Ibid.*

¹¹⁹ A NRO is a Canadian resident company that is an investment company owned by non-residents. *Ibid.*, Technical Explanation, Article 5(7)(a). Some U.S. multinationals use NROs as vehicles to finance Canadian operating subsidiaries. A U.S. parent can fund a NRO with equity that is then used to provide debt financing for the operating Canadian subsidiary. The interest payments on intra-affiliate debt reduces Canadian operating profits otherwise subject to Canadian corporate and withholding taxes, and which are subject to a fully refundable tax when the NRO pays a dividend to the U.S. parent. Prior to the Protocol NROs were also used to get a reduced withholding rate, the rate would be reduced from 15 percent to 10 percent. However, under the Protocol the minimum rate will be 10 percent not the new reduced rate of 5 percent. See *supra* note 13.

percent (instead of the standard rate of 5 percent) for dividends paid by NROs to a connected U.S. company.¹²⁰

ii. Interest:

Article 6 of the Protocol reduces the general maximum withholding rate on interest from 15 percent to 10 percent.¹²¹ Further, paragraph 3 of Article XI of the Convention provides that certain specified categories of interest are exempt from withholding at source. Prior to the Third Protocol, the Convention exempted interest paid by a purchaser to a seller when the interest was connected to the sale of equipment, merchandise or service. However, a person who purchased the indebtedness could not benefit from the exemption because they were not the seller.¹²² The Protocol broadens the exemption to apply to interest that is beneficially owned either by the seller in the underlying transaction, as under the present Convention, or by any beneficial owner of interest paid with respect to an indebtedness arising as a result of the sale on credit of equipment, merchandise, or services.¹²³ This exemption, however, does not apply in cases where the purchaser is related to the seller or the debtor is related to the beneficial owner of the interest.¹²⁴

¹²⁰ A connected company is a company that owns at least 10 percent of the voting stock of the NRO. *See supra* note 113, Technical Explanation Article 5(7). Canada wanted the withholding rate for direct investment NRO dividends to be no lower than the maximum withholding rates under the Convention on interest and royalties, in order to make sure that a foreign investor cannot transform interest or royalty income subject to a 10 percent withholding tax into direct dividends qualifying for a 5 percent withholding tax by passing it through to an NRO. *Ibid.*

¹²¹ *See* Appendix One; Third Protocol, Article 6. Additionally, paragraph 3 of Article 6 of the Protocol adds a new paragraph 9 to Article XI of the Convention. *See supra* note 121. New paragraph 9 provides that the reduced rates of tax at source for interest provided for in paragraphs 2 and 3 do not apply to residual interest in a real estate mortgage investment conduit ("REMIC"). This type of interest, therefore, remains subject to the statutory 30 percent U.S. rate of tax at source.

¹²² *See supra* Gelardi note 112 at 56.

¹²³ *See supra* note 113, Technical Explanation, Article 6.

¹²⁴ The reference to "related persons" in paragraph 3(d) of Article XI of the Convention, is amended, from the present Convention, which refers to "persons dealing at arm's length." The term "related person" as used in this Article is not defined in the Convention. Therefore, the meaning of the term will be governed by the domestic law of each Contracting State as dictated by the interpretative rule of paragraph 2 of Article III (General Definitions). The United States defines the term "related person" as under section 482 of the IRC, to include organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests. *Ibid.*

iii. *Royalties:*

The royalty provision, which eliminates source based taxation on royalty income, is one of the most important tax provisions regulating the cross-border flow of technology between Canada and the U.S.¹²⁵ Article 7 of the Protocol expands the classes of royalties exempt from withholding of tax at source.¹²⁶ Paragraph 3 identifies four classes of royalty payments that are exempt at source. First, copyright royalties in respect of literary and other works, not including certain payments in respect of motion pictures, and videotapes, are exempt from withholding tax. This is what was exempted as a cultural royalty under the Convention prior to the Third Protocol. Second, the exemption is extended to computer software royalties. This provision is in line with the OECD recommendation with respect to the treatment of computer software.¹²⁷ Third, the Protocol provides for a total exemption for royalties paid for the use of, or the right to use, patents and information concerning industrial, commercial, and scientific experience,¹²⁸ other than payments in connection with rental or franchise agreements.¹²⁹ This exemption provides an important step in facilitating cross-border flows of intellectual property. However, Professor Brown has argued that it may pose problems in its interpretation and application.¹³⁰ Finally, subparagraph (d) allows the Contracting States to reach an

¹²⁵ See *supra* note 103 at 608.

¹²⁶ See Appendix One; Third Protocol, Article 7.

¹²⁷ See *supra* note 103 at 597.

¹²⁸ The Treaty negotiators agreed that royalties paid for the use of, or the right to use, designs or models, plans, secret formulas, or processes are included under subparagraph 3(c) to the extent that they represent payments for the use of, or the right to use, information concerning industrial, commercial, or scientific experience. In addition, they agreed that royalties paid for the use of, or the right to use, "know-how," as defined in paragraph 11 of the Commentary on Article 12 of the OECD Model Income Tax Treaty, constitute payments for the use of, or the right to use, information concerning industrial, commercial, or scientific experience. See *supra* note 113, Technical Explanation, Article 7.

¹²⁹ The Treaty negotiators agreed that a franchise is to be distinguished from other arrangements resulting in the transfer of intangible property. They agreed that a license to use intangibles (whether or not including a trademark) in a territory, in and of itself, would not constitute a franchise agreement for purposes of subparagraph 3(c) in the absence of other rights and obligations in the license agreement or in any other agreement that would indicate that the arrangement in its totality constituted a franchise agreement. *Ibid.*

¹³⁰ Brown argues that there will be a problem with the interpretation and application of the phrase 'in connection with a rental or franchise agreement', which denies an exemption from the withholding in those situations. She argues that this phrase is not defined by the Protocol and its interpretation will severely broaden or limit its application. See *supra* note 103 at 598 & 601-604. Brown has also argued that the provision is unduly complex and arbitrary in the way it exempts only some payments for intellectual property from withholding. *Ibid.* at 609.

agreement, through an exchange of diplomatic notes, with respect to the application of paragraph 3 of Article XII to payments in respect of certain live broadcasting transmissions.¹³¹

Professor Brown has indicated that taxpayers should keep in mind several tax planning considerations if they want to arrange their affairs so as to minimize¹³² the withholding tax on royalty payments.¹³³ First, all transactions that qualify for an exemption from withholding should be delayed until the provisions of the Protocol come into effect. Second, until the third exemption from withholding is clarified all payments for transfer of technology should be classified as a payment for, or ancillary to, a patent royalty or a payment for know-how. Third, if there is a payment for a franchise or rental, any service component should be separated and clearly identified from the non-exempt portion. Fourth, if know-how or a patent will form part of a lease payment then separate contracts should be used for the know-how/patent component and the lease portion. Finally, until there are guidelines on the allocation of payments, the separate contact scenario should be used for any payment that includes an exempt portion and a non-exempt portion. Bearing in mind the above recommendations, taxpayers should also proceed with caution in drafting agreements until any uncertainty concerning the royalty provision has had time to sort itself out.¹³⁴

¹³¹ The provisions of paragraph 3 do not fully reflect the U.S. treaty policy of exempting all types of royalty payments from taxation at source, but Canada was not prepared to grant a complete exemption for all types of royalties in the Protocol. Although the Protocol makes several important changes to the royalty provisions of the present Convention in the direction of bringing Article XII into conformity with U.S. policy, the United States remains concerned about the imposition of withholding tax on some classes of royalties and about the associated administrative burdens. In this connection, the Contracting States have affirmed their intention to collaborate to resolve in good faith any administrative issues that may arise in applying the provisions of subparagraph 3(c). The United States intends to continue to pursue a zero rate of withholding for all royalties in future negotiations with Canada, including discussions under Article 20 of the Protocol. *See supra* note 113, Technical Explanation, Article 7. The Department of Finance indicated that it has limited objectives for any exemptions under this subparagraph, that is an exemption for live and taped broadcast new material. *See supra* note 103 at 598.

¹³² Minimizing or eliminating a withholding tax is important because; 1) a withholding tax is based on gross payments and could exceed the foreign tax credit relief that is available that year; and 2) it becomes more complex and expensive when a taxpayer is required to file and report income tax in more than one jurisdiction, pay tax and then seek a foreign tax credit, the optimum result would be an exemption at the source and thus filing in a single jurisdiction. *Ibid.* at 608.

¹³³ *Ibid.* at 608.

¹³⁴ *Ibid.* at 609.

B. Taxes Imposed by Reason of Death:

Article 19 of the Protocol adds new Article XXIX B to the Convention.¹³⁵ This is a major new Article that address some of the problems that arise because of the different treatment of death in the domestic tax laws of Canada and the U.S.¹³⁶ The purpose of the new Article is to better coordinate the operation of the death tax regimes of Canada and the U.S. This is necessary because the U.S. imposes an estate tax while Canada deems capital gains to be realized at death and imposes an income tax on the capital gain by way of a deemed disposition on death of the capital property owner.¹³⁷ Article 19 is retroactive in effect and applies to deaths occurring after November 10, 1988.

i. Unified Credit:

Paragraph 2 grants a unified credit to the estate of a Canadian resident decedent for the purpose of computing U.S. estate tax.¹³⁸ Under the IRC, U.S. citizens or residents are subject to U.S. estate tax on their¹³⁹ entire worldwide assets, but they are entitled to a unified estate tax credit of \$192,800, which exempts the first \$600,000 of the estate from tax.¹⁴⁰ A non-resident who is not a citizen is subject to U.S. estate tax only on its U.S. situs assets and is entitled to a unified credit of only \$13,000, which exempts the first \$60,000 from estate tax.¹⁴¹ The estate tax rate on assets that are not sheltered by the credit ranges from 18 percent to 55 percent. Paragraph 2 sets the unified credit provided to Canadian resident decedents' estates to an amount between \$13,000 and \$192,800, depending on the ratio of word-wide assets that are situated in the U.S. The unified credit

¹³⁵ See Appendix One; Third Protocol, Article 19.

¹³⁶ See *supra* Gelardi note 112 at 61.

¹³⁷ See *supra* note 113, Technical Explanation; Article 19.

¹³⁸ See *supra* note 135. This is the first convention in which the U.S. has agreed to give a unified estate tax credit. See *supra* note 113, Technical Explanation; Article 19.

¹³⁹ In an effort to utilize gender neutral language I have endeavored to use neutral terms such as taxpayer, resident or they/them/their. Where this has not been possible I have attempted to use she/her and he/him interchangeably and I have attempted to use both genders an equal number of times each.

¹⁴⁰ IRC section 2010.

¹⁴¹ IRC section 2102.

allowed to a Canadian resident decedent is determined by multiplying \$192,800 by a fraction, the numerator of which is the value of the estate situated in the U.S. and the denominator of which is the value of the entire gross estate.¹⁴² For example, if a Canadian resident has worldwide assets of \$2 million and \$500,000 of the estate is situated in the U.S., the Canadian would be entitled to a unified credit of \$48,200 (25 percent of \$192,800). This would exempt the first \$150,000 (25 percent of \$600,000) of the U.S. assets from U.S. estate tax.¹⁴³ Prior to the Protocol, only the first \$60,000 of the U.S. sited assets would be exempt from U.S. estate tax. However, note that the unified credit is reduced by the amount of any unified credit previously allowed against U.S. gift tax.¹⁴⁴ Additionally, the unified credit is only available if all the required information is provided to the Internal Revenue Service ("IRS") to support the calculation.¹⁴⁵ Further, the amount of worldwide assets will be determined by U.S. rules. This means, for example, that the proceeds of life insurance policies are included as part of worldwide assets, which lowers the ratio of U.S. assets to worldwide assets and, consequently, the amount of the unified credit.¹⁴⁶

ii. *Martial Credit:*

Paragraph 3 allows an additional martial credit against U.S. estate taxes in respect of certain transfers to a surviving spouse.¹⁴⁷ U.S. domestic law permits an unlimited deduction for transfers to a decedent's spouse, but only if the spouse is a U.S. citizen.¹⁴⁸ The Protocol changes this rule by permitting a credit against estate tax where the deceased

¹⁴² See *supra* note 113, Technical Explanation; Article 19.

The formula for the unified credit is $\$192,800 \times (\text{value of estate in the U.S.} / \text{value of the entire world-wide estate})$.

¹⁴³ See *supra* Gelardi note 112 at 61.

¹⁴⁴ Under U.S. law a U.S. citizen or resident is entitled to a total unified credit of \$192,800. Thus the amount of any unified credit for use against an individual's estate tax is reduced by the amount of any unified credit that has been allowed for any gift tax owing.

¹⁴⁵ Elaine E. Reynolds and Benita Loughlin, *The Third Protocol: An Estate Tax Dream Come True?*, 53 The Advocate 569, 570 (1995).

¹⁴⁶ *Ibid.*

¹⁴⁷ See *supra* note 135.

¹⁴⁸ IRC section 2056.

is a U.S. citizen or a resident of either Canada or the U.S. and the property is transferred to the surviving spouse who is resident of either country. The marital credit is in addition to the unified credit, but it cannot be greater than that amount.¹⁴⁹ Thus, if property is left to a spouse or spousal trust there is an effective doubling of the credit. However, the couple must be legally married. U.S. rules apply for this purpose and, unlike Canada, the U.S. does not recognize a common law marriage.¹⁵⁰

Canada does not tax a decedent's estate but rather deems a disposition at death of capital property and taxes any capital gain on the decedent's final return. Assets transferred to the surviving spouse, who must be a resident of Canada, or to a resident spousal trust are deemed to be transferred at cost, resulting in no capital gain to be taxed.¹⁵¹ However, the tax free transfer does not apply if the decedent was not a resident of Canada at the time of death. Under paragraph 5 the protocol deems a U.S. resident decedent and the surviving spouse or spousal trust to be resident of Canada and thus eligible for the tax free transfer.

The marital credit protects the assets against estate tax upon the bequest to the surviving spouse. The property will be included in the surviving spouse's estate and subject to estate tax in the future. The future estate tax could be avoided on the death of the survivor if the U.S. situs assets had been disposed of by the survivor and the proceeds reinvested in assets that do not attract estate tax.¹⁵²

¹⁴⁹ An example that illustrates the operation of the marital credit and the unified credit is assume that decedent H, a citizen and resident of Canada, has worldwide assets of \$1,200,000, \$600,000 of which is U.S. situs property. He bequeaths all the U.S. property to his wife, also a citizen and resident of Canada. The estate would be entitled to unified credit of \$96,400 ($\$192,800 \times (\$600,000 / \$1,200,000)$) and to a marital credit of the same amount. The U.S. estate tax that would otherwise be imposed is \$192,800. The combined unified and marital credits eliminate all the estate tax with respect to the property transferred to the wife. *See supra* note 113, Technical Explanation; Article 19 – Marital credit examples.

¹⁵⁰ *See supra* note 145 at 570.

¹⁵¹ ITA section 70(5), (6).

¹⁵² *See supra* note 145 at 570.

iii. Tax Credit:

The differences between the U.S. estate tax regime, which imposes taxation on the value of a person's assets at the time of death, and the Canadian system, that deems a disposition upon death and the taxes any accrued capital gain, leads to double taxation because these taxes are generally not creditable taxes for foreign tax credit purposes.¹⁵³ The Protocol addresses this problem. Under paragraph 6 Canada will give Canadian residents and Canadian resident spousal trusts a credit for any U.S. federal or state estate or inheritance taxes on U.S. situs property. The credit is applied to the total amount of Canadian income tax payable by the decedent on *any* income, profits or gains arising in the U.S. This includes gains deemed realized at death on U.S. situs real property, U.S. dividend or interest income, and U.S. business or employment income. Similarly, under paragraph 7 the U.S. will give a credit against U.S. federal estate tax for any Canadian federal or provincial income tax imposed due to the death of a U.S. citizen or resident on non-U.S. sited property. Thus the Canadian tax on any capital gains in respect of real and personal property forming part of the business property of a permanent establishment in the U.S. can be offset by the deduction.¹⁵⁴ Further, the deduction can be used against any Canadian tax on U.S. source dividends, interest, rents and royalties.¹⁵⁵

iv. Relief for Small Estates:

Under paragraph 8 of Article XXIX B, small Canadian estates are provided with relief from the application of U.S. estate tax. This provision is intended to eliminate the "trap for the unwary" that exists for decedents with small estates, who hold U.S. situs property and inadvertently subject their estates to U.S. estate tax by failing to employ sophisticated estate tax planning.¹⁵⁶ Paragraph 8 provides relief to Canadian resident decedents whose worldwide gross estate is less than \$1.2 million by allowing U.S. estate

¹⁵³ See *supra* Gelardi note 112 at 63.

¹⁵⁴ See *supra* note 145 at 571.

¹⁵⁵ *Ibid.*

¹⁵⁶ See *supra* note 113, Technical Explanation; Article 19.

tax only if any gain on alienation of the property would have been subject to U.S. income tax under Article XIII (Gains). Thus, the U.S. cannot impose its estate tax on property that would not be subject to tax if the decedent had disposed of it during her lifetime. For example, the shares of a Canadian corporation that has only one asset – real property in the U.S. – would be included as an asset to which Article XIII applies.¹⁵⁷ But, shares of a foreign corporation are not regarded as a U.S. real property interest under U.S. domestic law¹⁵⁸ and any gain from the disposition of such shares will not be taxed in the U.S., and thus will not be subject to estate tax.¹⁵⁹

v. *Charitable Bequests:*

Paragraph 1 provides that the contracting states will accord the same tax treatment on death to charitable bequests by an individual resident in one contracting state to a qualifying exempt organization¹⁶⁰ resident in the other contracting state.¹⁶¹ Essentially, each contracting state is obligated to treat charitable organizations resident in the other contracting state as a resident of that state. Under this paragraph a U.S. estate tax deduction will be allowed for a bequest by a Canadian resident to a qualifying exempt organization that is a U.S. or Canadian corporation.¹⁶²

vi. *Summary:*

The addition of Article XXIX B to the Convention will not necessarily eliminate the estate tax planning problems of all Canadians owning U.S. situs property. In fact, it will now be more difficult to predict the actual consequences on death.¹⁶³ Any planning will have to be re-evaluated on a regular basis to take into account changing ratio of the

¹⁵⁷ See *supra* Gelardi note 112 at 64.

¹⁵⁸ IRC section 897(c).

¹⁵⁹ *Ibid.*

¹⁶⁰ The qualifying exempt organizations referred to in this paragraph are those specified in paragraph 1 of Article XXI (Exempt Organizations). See *supra* note 113, Technical Explanation; Article 19.

¹⁶¹ See *supra* note 135.

¹⁶² See *supra* note 113, Technical Explanation; Article 19.

¹⁶³ See *supra* note 145 at 570.

value of U.S. situs property to worldwide assets.¹⁶⁴ High net worth individuals will only be better off only if they can claim U.S. estate tax as a foreign tax credit or deduction against Canadian taxes.¹⁶⁵ The ability to use U.S. estate taxes as a foreign tax credit or deduction against Canadian taxes depends on the type of U.S. property owned, the ratio of worldwide assets, the accrued gain and the exchange rate at the time. Thus complicated and careful planning will be required on an ongoing basis to obtain the optimum tax result from the new provisions under the Protocol.

Several new planning opportunities exist under the Protocol. First, consider the of the unified tax credit, which based on the ratio of U.S. assets to worldwide assets. An individual can obtain the largest possible credit by limiting her non-U.S. assets or by transferring her non-U.S. assets to her spouse. A decedent who does not own any U.S. real estate is not subject to U.S. estate tax if her worldwide assets are less than \$1.2 million U.S. at her time of death. Thus in a marriage one spouse should own all the non-U.S. real estate and the other spouse should own all the U.S. situs property.¹⁶⁶ Second, one should exclude life insurance proceeds from the calculation of worldwide assets because this allows for a larger unified credit.¹⁶⁷ This can be done through careful planning so the decedent does not have any incidents of ownership of the life insurance proceeds. Third, U.S. source income should be created in the year of death to utilize any foreign tax credit against Canadian tax payable.¹⁶⁸ The U.S. estate may not result in extra tax if the Canadian resident decedent is subject to Canadian capital gains tax on the deemed disposition of death of U.S. situs property that is considered U.S. source income or the gain is from U.S. situs property and the estate is valued over \$1.2 million U.S. Finally, if the Canadian deemed disposition on death is deferred because the property is transferred to a Canadian resident spouse or spousal trust then it should be ensured that

¹⁶⁴ *Ibid.*

¹⁶⁵ *Ibid.*

¹⁶⁶ *Ibid.* at 572.

¹⁶⁷ *Ibid.*

¹⁶⁸ *Ibid.*

U.S. estate tax is also deferred so that Canadian tax on gain and the U.S. estate tax are payable in the same year, and any foreign tax credit can be utilized at that time.¹⁶⁹

C. Administration:

i. Arbitration:

Article 14 of the Protocol amends Article XXVI (Mutual Agreement Procedure) of the Convention by adding a voluntary arbitration procedure for disputes that cannot be resolved under the existing Mutual Agreement Procedure.¹⁷⁰ A matter will only go to arbitration on the consent of the taxpayer and both contracting states. While arbitration is voluntary, the decision of the arbitration board will be binding on the taxpayer and the contracting states. The U.S., however, was reluctant to implement the arbitration procedure until it had the opportunity to evaluate similar procedures in its other conventions.¹⁷¹ Thus, it was agreed that the arbitration procedure will not be implemented until the exchange of diplomatic notes, which has not yet happened. Additionally, the contracting parties are required to wait 3 years after the entry into force of the Protocol before entering into negotiations concerning the exchange of diplomatic notes.¹⁷²

ii. Assistance in Collection:

A major new article has been added to the Convention that provides that contracting states will assist each other in the collection of revenue claims (outstanding taxes).¹⁷³ A revenue claim includes all taxes collectable and interest, costs, additions and civil penalties. Article XXVI A provides specific procedures that ensure that the amount due is collectable under the laws of the requesting country. Paragraph 2 requires that the contracting state applying for collection assistance certify that the revenue claim has been

¹⁶⁹ *Ibid.*

¹⁷⁰ See Appendix One; Third Protocol, Article 14.

¹⁷¹ See *supra* note 113, Technical Explanation; Article 14.

¹⁷² See Appendix One; Third Protocol, Article 20.

¹⁷³ See Appendix One; Third Protocol, Article 15.

finally determined.¹⁷⁴ Paragraph 3 states that the contracting states have the discretion to accept or reject a particular application for collection assistance. If the application for assistance is accepted, the requested state must treat the revenue claim as if it was finally determined under its own laws. The ordinary costs incurred in collection assistance are to borne by the requested state and only extraordinary costs will be borne by the applicant state.¹⁷⁵

Paragraph 5 provides this Article does not create any rights of administrative or judicial review of the applicant state's finally determined revenue claim. However, if the revenue claim ceases to be finally determined, the applicant state is required to promptly withdraw its request. Further, paragraph 8 provides that no assistance will be given if taxpayer can demonstrate that she was a citizen of the requested state during the taxable period to which the revenue claim relates.¹⁷⁶

The U.S. now has four mutual collection agreements worldwide, with Canada, France, the Netherlands and Sweden.¹⁷⁷ These agreements have only been rarely used. As of February 1996, the agreement with France is the only one used, and only in a single instance. However, U.S. Treasury Department officials predict an increased level of activity with the U.S.-Canada agreement.¹⁷⁸

¹⁷⁴ A revenue claim has been finally determined when the applicant state has the right under its internal law to collect the revenue claim and all administrative and judicial rights of the taxpayer to stop collection have been exhausted.

¹⁷⁵ See *supra* note 173, Paragraph 6.

¹⁷⁶ Many former Canadian residents who have secured U.S. citizenship, and U.S. residents who have acquired Canadian citizenship, may not be exempt from revenue claims asserted by Canada, or the U.S., because they usually will not have been U.S. citizens, or Canadian citizens, when the claims arose (i.e., when they were residents of Canada, or the U.S.). These taxpayers may want to consider implementing asset protection techniques to protect against possible claims by Revenue Canada or the IRS. However, the critical question will be whether a particular transfer of assets would violate the particular state's Fraudulent Conveyances Act. Bruce N. Lemons, Thomas H. Olson and L. Alan Rautenberg, *Changes in U.S.-Canadian Tax Treaty Resolve conflicts and Present Planning Opportunities*, 82 J. of Tax 42 (Jan. 1995).

¹⁷⁷ See Lyons *infra* note 236.

¹⁷⁸ *Ibid.*

iii. *Elimination of Double Taxation:*

Article 12 of the Protocol amends Article XXIV (Elimination of Double Taxation) of the Convention. Paragraph 1 of Article 12 amends the rules for Canadian double taxation relief. Subparagraph (a) provides a Canadian foreign tax credit for U.S. social security taxes. This provision applies only to the Canadian foreign tax credit system since contributions to the Canadian Pension Plan are already considered to be eligible for the U.S. foreign tax credit since they are 'like taxes' under U.S. domestic law.¹⁷⁹ Subparagraph (b) continues the exemption for Canadian corporations for direct dividends paid from the exempt surplus of a U.S. affiliate.¹⁸⁰ Finally, the foreign tax credit system for U.S. citizens resident in Canada was slightly amended to take into account the new withholding rates for dividends, interest and royalties. This paragraph provides that any income that is exempt from taxation under the Convention can still be included in a taxpayer's calculation of its foreign tax credits.¹⁸¹

iv. *Non-Discrimination:*

Article 13 of the Protocol amends Article XXV (Non-Discrimination) of the Convention.¹⁸² Previously, the Convention mandated a deduction in the taxable income for non-resident dependents as if the dependent was a resident of the non-resident's country. This created a conflict since Canada no longer provides a deduction calculation of taxable income, but allows a non-refundable tax credit for certain dependents.¹⁸³ Paragraph 1 of Article 13 incorporates this change by allowing a deduction from tax payable as well as from taxable income. Paragraph 2 extends the non-discrimination clause to include *all* taxes imposed by Canada and the U.S., not merely taxes under the ITA and the IRC.

¹⁷⁹ See *supra* Gelardi note 112 at 67.

¹⁸⁰ See *supra* note 113, Technical Explanation, Article 12 and Appendix One; Third Protocol, Article 12.

¹⁸¹ See Appendix One, Third Protocol, Article 12, paragraph 4.

¹⁸² See Appendix One, Third Protocol, Article 13.

¹⁸³ See *supra* Gelardi note 112 at 67.

v. *Exchange of Information:*

Article 16 of the Protocol amends Article XXVII (Exchange of Information) of the Convention.¹⁸⁴ This Article allows information to now be shared with provincial and state governments. Additionally, the scope of this Article is expanded to allow the exchange of information concerning all taxes imposed by the contracting states, not merely taxes imposed under the ITA and IRC. For example, information can now be exchanged concerning Canadian and U.S. excise taxes.

D. Other Provisions:

i. *Taxes Covered:*

Article 1 of the Protocol amends Article II of the Convention to increase the number of taxes covered.¹⁸⁵ The Convention now applies to *all taxes* imposed by the Government of Canada under the ITA. The Convention also applies to all taxes imposed by the United States Government. However, in specified situations the Convention applies to certain taxes only to the extent necessary to implement specific provisions of the Convention. The Protocol also clarifies that the Convention applies to all future identical or substantially similar taxes.

ii. *Residence:*

Article 3 of the Protocol amends Article IV (Residence) of the Convention.¹⁸⁶ The definition of a resident has been extended and restricted by this Article. Paragraph 1 restricts the definition of residence by stating that a person will be considered to be a resident for purposes of the Convention if she is liable to tax in that Contracting State by reason of domicile, residence, citizenship, place of management, or place of

¹⁸⁴ See Appendix One; Third Protocol, Article 16.

¹⁸⁵ See Appendix One; Third Protocol, Article 1.

¹⁸⁶ See Appendix One; Third Protocol, Article 3. See *The Queen v. Crown Forest Industries Limited*, 95 D.T.C. 5389 (S.C.C.) for the Canadian Supreme Court's latest decision concerning residency of a corporation under the Convention, see *infra* note 517.

incorporation.¹⁸⁷ Prior to this change there was concern that persons with little connection with the U.S. could avail themselves of treaty benefits to which the U.S. was a contracting state by becoming a green card holder.¹⁸⁸ To prevent this, Article 3 provides that a green card holder who is not a resident of Canada will be treated as a U.S. resident only if she has a substantial presence, permanent home or habitual abode in the U.S. and her personal and economic relations are closer to the U.S. than to a third country.

Paragraph 3 expands the definition of a corporation's place of residence. Prior to the Protocol, a corporation that was continued from one country to another was considered to be a resident of the country of its incorporation. Paragraph 3 changes this and provides that a corporation that it continued is resident in the country it has been continued.

iii. Gains:

Article 8 of the Protocol broadens the scope of paragraph 8 of Article XIII (Gains) of the Convention to allow tax-free rollovers for certain organizations, reorganizations, and amalgamations involving either corporations or other entities.¹⁸⁹ Prior to the Protocol, the Convention limited deferral to transactions involving corporations. The amendment expands the type of tax-free reorganizations to include transactions involving other types of entities, such as trusts and partnerships.¹⁹⁰

iv. Pensions and Annuities:

Article 9 of the Protocol amends Article XVIII (Pensions and Annuities) of the Convention.¹⁹¹ The Protocol amends the definition of "pensions" by substituting the

¹⁸⁷ See Appendix One, Third Protocol, Article 3.

¹⁸⁸ See *supra* Gelardi note 112 at 68. For example a green card holder who lived in a country that did not have a treaty with Canada and who received Canadian dividends could obtain a lower treaty withholding rate through their deemed residence in the U.S. the green card provided. *Ibid.*

¹⁸⁹ See Appendix One, Third Protocol, Article 8.

¹⁹⁰ See *supra* note 113, Technical Explanation Article 8.

¹⁹¹ See Appendix One, Third Protocol, Article 9.

phrase “other retirement arrangement” for the phrase “retirement plan,” clarifying that the definition of “pensions” includes payments from Individual Retirement Accounts (“IRAs”) in the United States and Registered Retirement Savings Plans (“RRSPs”) and Registered Retirement Income Funds (“RRIFs”) in Canada.¹⁹² Paragraph 2 of Article 9 of the Protocol amends paragraph 5 of Article XVIII to modify the treatment of social security benefits under the Convention. Under the amended paragraph, benefits paid under U.S. or Canadian social security legislation to a resident of the other Contracting State are taxable only in the country that pays them, not in the country where the payee resides. Thus, a Canadian citizen who resides in Florida and receives social security payments from Canada will only be taxable in Canada for those payments.

v. *Exempt Organizations:*

Article 10 paragraph 1 of the Protocol amends Article XXI (Exempt Organizations) to clarify that the definition of exempt organizations,¹⁹³ which are exempt from taxation in the other contracting state, includes U.S. IRAs and Canadian RRSPs and RRIFs.¹⁹⁴ Further, Article 10 paragraph 3 of the Protocol amends Article XXI paragraph 6 of the Convention to deem gifts to U.S. registered charitable organizations by Canadians as gifts to Canadian registered charities that are deductible for Canadian tax purposes.

vi. *Other Income:*

Article 11 of the Protocol adds a novel paragraph 3 to Article XXII (Other Income) of the Convention.¹⁹⁵ This paragraph will entitle residents of Canada who are taxable by the U.S. on gains from gambling transactions to deduct those losses for the purposes of taxation in the United States. Wagering losses in the U.S. will only be deductible to the extent that there are gains from wagering in the U.S. This provision applies both to the deduction of wagering losses by Canadians in the U.S. and Americans

¹⁹² See *supra* note 113, Technical Explanation, Article 9.

¹⁹³ See Appendix One; Third Protocol, Article 10.

¹⁹⁴ See *supra* note 113, Technical Explanation, Article 10.

¹⁹⁵ See Appendix One; Third Protocol, Article 11.

in Canada. However, since Canada does not at the present time include gains from wagering in income, the provision applies only to the wagering losses of Canadians in the U.S.¹⁹⁶

¹⁹⁶ The United States imposes a 30 percent withholding tax on gains from wagering under IRC section 1441 or 1442. In calculating their U.S. income tax liability Canadian residents can reduce their gains from wagering transactions subject to U.S. withholding tax to the extent of any wagering losses that are deductible under IRC section 165. In order to substantiate the losses and obtain a refund of a U.S. withholding tax, a Canadian resident will be required to file a non-resident income tax return, form 1040NR. Technical Explanation, Article 11.

U.S. TAX TREATY POLICY AND THE EVOLUTION OF LIMITATION ON BENEFITS PROVISIONS:

In this chapter, I shall discuss U.S. tax treaty policy and review the evolution of LOB provisions in U.S. tax treaties. I shall then discuss why, as Canada has prohibitively high tax rates and is accordingly an inferior location for treaty shopping, the U.S. insisted on including the LOB Article in the Protocol. I conclude this chapter by discussing why, since LOB provisions are contrary to Canadian tax treaty policy and may potentially harm Canadian resident taxpayers, Canada agreed to its inclusion in the Protocol.

Tax Treaty Policy:

Canada, Mexico and the United States are all committed to the basic policy that, in order to foster international trade and investment, international business income should not be subject to double taxation.¹⁹⁷ The policy instruments to achieve this goal are found in their respective foreign tax credit mechanisms, their bilateral tax treaties and the free trade provisions of NAFTA. However, at the same time these countries have become more aware that one of the greatest benefits they receive from the presence of foreign investment within their borders is the tax revenue they are able to collect from the income generated by these investments.¹⁹⁸

Ensuring that foreign investment income does not escape the application of withholding taxes, particularly through treaty shopping, has become one of the central pillars of U.S. tax treaty policy. The U.S. policy of preventing treaty shopping has in recent years become more intensified as the U.S. has switched roles from being a creditor nation to being a debtor nation. In its current status as a debtor nation, significantly more investment income is flowing out of the U.S. to foreign investors. Consequently, the U.S. has an economic incentive to apply the maximum possible withholding tax rate on foreign

¹⁹⁷ See *supra* note 101 at 143.

¹⁹⁸ *Ibid.* at 144.

investment income, as this will increase its tax revenue. One way the U.S. has attempted to accomplish this is through the inclusion of anti-treaty shopping provisions in its domestic tax law and its tax treaties. In this way, the U.S. can increase its tax revenue without incurring the political backlash of U.S. domestic taxpayers.

Ironically, a review of U.S. tax legislation and U.S. tax treaties reveals that the term 'treaty shopping' does not appear anywhere in those documents.¹⁹⁹ However, the U.S. has for some time been concerned with treaty shopping, whereby third country residents use bilateral income tax treaties to avoid paying U.S. withholding taxes.²⁰⁰ Commencing in the late 1970's the U.S. Treasury Department and the IRS began, through unilateral and bilateral actions, to limit the availability of treaty benefits through tax havens and countries that permitted the use of conduits in their jurisdiction.²⁰¹ In 1981, the Treasury Department stated that in future treaty negotiations it would begin to restrict the availability of U.S. tax treaty benefits.²⁰² Also in 1981, the Treasury Department issued a revision to its Model Tax Treaty that included a LOB provision that the U.S. would use in future tax treaties to limit treaty benefits to 'real' residents of tax treaty contracting states.²⁰³ The Treasury Department embarked on an aggressive campaign to renegotiate U.S. tax treaties that did not have an LOB provision, by insisting that such a provision be included in all U.S. tax treaties.²⁰⁴ The idea of a LOB provision achieved a life of its own, being pursued not only by the U.S. Treasury Department but, with even more force by Congressional task writing committees and by the U.S. Senate Foreign Relations Committee which is responsible for issuing its advice and consent for U.S. tax treaties.²⁰⁵

¹⁹⁹ See *supra* note 42 at 289.

²⁰⁰ See *supra* note 45 at 626.

²⁰¹ William P. Streng, "Treaty Shopping": Tax Treaty "Limitation on Benefits" Issues, 15 Houston J. of Int'l L. 1, 7 & 10 (1992).

²⁰² *Ibid.*

²⁰³ *Ibid.* at 7-8. When revising a treaty the U.S. Model Treaty was used as a starting point and yardstick for comparing derivations from the norm. However, recent U.S. tax treaties have moved so far from the Model that it can no longer be regarded as an appropriate model. In fact on July 17, 1992, the Model Treaty was withdrawn and the Treasury Department announced that it is in the process of drafting a new Model. *Ibid.* at 11-12 & note 32.

²⁰⁴ Ian K. Sugarman, *The U.S.-Netherlands Income Tax Treaty: Closing the Doors on The Treaty Shoppers*, 17 Fordham Int'l L.J. 776, 778 (1994).

²⁰⁵ *Ibid.* at 11.

The policy of including LOB provisions in every U.S. tax treaty has become so overriding that the U.S. Senate has explicitly rejected several treaties because they did not include such an article.²⁰⁶

The U.S. desire to stop treaty shopping is based on several rationales. First, the U.S. argues that treaty shopping discourages the conclusion of tax treaties. If residents of third countries are able to shop for treaty benefits in the existing treaty network, there will be no need for third countries to enter into tax treaties with the U.S., as their residents are already obtaining treaty benefits.²⁰⁷ This is at odds with the U.S. policy of concluding treaties with all of its major trading partners, for these countries will have no incentive to enter into a treaty with the U.S. Second, treaty shopping results in lost revenue. The proliferation of tax treaties between the U.S. and tax havens in the 1960's and 1970's has resulted in an increased loss of tax revenues and has caused the IRS to focus on the problem of treaty shopping.²⁰⁸ Additionally, the current role of the U.S. as a debtor nation has created the potential, if the U.S. is able to maximize the withholding taxes on foreign investment income, for increasing U.S. tax revenues at the expense of foreign investors. Third, the U.S. claims that treaty shopping directly and indirectly discriminates against U.S. residents. The U.S. has an extensive treaty network which makes it difficult for U.S. residents to treaty shop and thus the U.S. argues that residents of third countries should likewise not be able to treaty shop.²⁰⁹ Fourth, the U.S. policy in negotiating tax treaties is that these treaties should not materially differ from the IRC.²¹⁰ U.S. policy is that anti-

²⁰⁶ See *supra* note 201 at 27.

²⁰⁷ See *supra* note 1 at 581.

²⁰⁸ *Ibid.* at 626-27. The U.S. unintentionally, and unwittingly, entered into tax treaties with over a dozen tax havens when in 1959 it agreed to extend the U.S.-U.K. Tax Treaty to British territories. Subsequently, many of these territories became tax havens after they declared themselves independent from the U.K. and agreed to be bound by the U.S.-U.K. Tax Treaty. *Ibid.* at 634-35. By 1976, the IRS focused more intensely on treaty shopping as the U.S. had lost significant amounts of tax revenue as a result of treaty shopping through these tax havens. See *supra* note 1 at 583.

²⁰⁹ See *supra* note 1 at 581-82.

²¹⁰ *Ibid.* at 582.

treaty shopping provisions in the IRC, such as the branch profits tax provisions, should be reflected in all its tax treaties.²¹¹

It can be argued that U.S. bilateral tax treaty policy has an inherent tension between the policy of raising tax revenue and compelling tax compliance on the one hand, and the encouragement of the international free flow of capital on the other hand.²¹² Bilateral tax treaties are bargains analogous to contractual agreements between nations that reflect the economic policy concerns of treaty countries and reconcile the differences in their domestic tax codes that inhibit cross-border trade and investment.²¹³ LOB articles, and analogous domestic tax provisions, favour a narrow view as to which residents are entitled to tax treaty benefits.²¹⁴ Under this view a resident must demonstrate a sufficient nexus with the resident country in order to be a “qualifying resident.” This is at odds with the traditional view, accepted in the rest of the world, which extends treaty benefits to anyone who meets a basic residency test and is the beneficial owner of the income for which treaty benefits are sought.²¹⁵ By insisting on the inclusion of LOB articles in all U.S. tax treaties, and passage of the branch profits tax provisions, the U.S. Congress clearly stated its position on international tax relations – it would only tolerate limited treaty shopping because it desired an increased tax base.²¹⁶

The LOB provisions were introduced into U.S. tax treaties at the time the U.S. switched roles from being a capital exporting nation to a capital importing nation.²¹⁷ As the U.S. increasingly became a capital importing nation, significant U.S. tax revenues were

²¹¹ The branch tax profits provisions in the IRC were an unilateral response by the U.S. to countries which refused to bilaterally accede to the inclusion of LOB provisions in their tax treaties with the U.S. If the U.S. is unable to bilaterally prevent treaty shopping then it is more than willing to take unilateral measures to prevent treaty shopping, regardless of whether such unilateral action will abrogate its bilateral tax treaties, and thus violate international law.

²¹² See Kim *infra* note 324 at 985.

²¹³ *Ibid.* at 986.

²¹⁴ Paul H. Sleurink and Richard E. Andersen, *U.S.–Dutch Treaty Reflects Changed Policies and Economic Forces*, 4 J. of Int'l Tax 104 (1993).

²¹⁵ *Ibid.*

²¹⁶ See *supra* note 22 at 372.

²¹⁷ See *supra* note 201 at 9.

at risk because third country residents were able to escape withholding taxes on U.S. source income through treaty shopping.²¹⁸ The LOB provision is a recognition of increasing investment profit payments from the U.S. to foreign investors and the U.S. desire tap into this flow of investment income by obtaining the maximum withholding at the source. Therefore, it can be concluded that the U.S. Congress favours a policy of strict tax compliance over a policy of freer capital movement.²¹⁹ For these reasons, and the four reasons listed above, it was inevitable that the U.S. would insist that the Third Protocol contain a LOB provision that has specific criteria Canadian residents must satisfy before being entitled to treaty benefits.

History and Evolution of the LOB Provision:

The U.S. has attempted to limit treaty shopping through a two pronged attack.²²⁰ This assault on treaty shopping was based on U.S. tax treaty policy that every tax treaty should include an anti-treaty shopping article or alternatively the U.S. unilaterally will override inconsistent tax treaties through domestic tax legislation.²²¹ Initially, the U.S. attempted to prevent treaty shopping through tax court decisions and IRS administrative rulings that denied treaty benefits to intermediary companies through the application of the substance over form doctrine.²²² The next step involved extensively revising the IRC to

²¹⁸ *Ibid.* at 51.

²¹⁹ *Ibid.*

²²⁰ See *supra* note 200 at 629–30.

²²¹ See *supra* note 204 at 778. A conflict exists between the power of the U.S. Congress to override treaty obligations through unilateral legislation and the obligation of the U.S. government to adhere to negotiated agreements with its trade partners. The United States Constitution, in Article VI, 2 Section 2, states that the “laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme law of the land....” This section was interpreted by the U.S. Supreme Court to mean that tax treaties should be accorded equal weight to U.S. federal statutes. *Reid v. Covert*, 354 U.S. 1, 18 (1957). The U.S. Supreme Court also held that in the case of a conflict between a tax treaty and a federal statute the latest one passed will control. *Whitney v. Robertson*, 124 U.S. 190, 194 (1888). For a discussion of this topic see *ibid.* at 793.

²²² For examples of court decisions see: *Johansson v. United States*, 336 F.2d 809 (5th Cir. 1964) where the U.S. Court of Appeals denied treaty benefits to a U.S. boxer who, as a Swedish heavyweight boxing champion, attempted to take advantage of an exemption clause in U.S.–Swiss Tax Treaty; and *Aiken Indus., Inc. v. Commissioner*, 56 T.C. 925 (1971) which held that a Honduran corporation was not the true recipient of interest, and therefore, not entitled to a treaty exemption. In 1984 the IRS issued two important revenue rulings that were its most direct attack against treaty shopping. In Rev. Rul. 84–152, 1984–2 C.B. 381 the IRS denied a reduced withholding tax on interest paid on loan from Swiss corporation through its Netherlands Antilles subsidiary.

contain provisions to limit treaty shopping. The U.S. passed the Tax Reform Act ("TRA") of 1986 which promulgated stringent branch profits tax rules that applied to treaty shopping situations regardless of any existing tax treaties that may have allowed treaty shopping.²²³ Section 884(e) of the IRC, the branch profits tax provision, seeks to prevent treaty shopping by expressly limiting treaty benefits to qualified residents of countries who are party to a U.S. tax treaty. The branch profits tax applies a 30 percent withholding rate, notwithstanding any prohibition or limitation in a U.S. tax treaty.²²⁴ This tax is imposed in addition to the regular corporate income tax applicable to U.S. net profits.²²⁵ Only foreign corporations that are substantially connected to a country with which the U.S. has a treaty are entitled to reduced branch profits taxes under that treaty. The branch profits tax provisions and its regulations, in contrast to scanty LOB provisions in early U.S. tax treaties, improved the effectiveness of U.S. anti-treaty shopping

Similarly, in Rev. Rul. 84-153, 1984-2 C.B. 383 the IRS determined that financing through an Antilles corporation was subject to a 30 percent withholding rate as this it was engaged in treaty shopping.

²²³ The branch profits tax rules are founding IRC section 884 *et seq.* These rules are an extension of the taxing jurisdiction of the U.S. over dividends and interest paid by the branch offices of foreign corporations doing business in the U.S. See *supra* note 22 at 370 & note 72. The U.S. justifies these rules as an attempt to equalize the tax treatment of branches of non-U.S. companies with that of domestic subsidiaries. See *supra* note 204 at 795. However, the U.S. tax treaty partners argue that section 884 potentially violates U.S. tax treaties because only non-U.S. corporations are subject to branch profits taxation. The majority of U.S. tax conventions include non-discrimination clauses to ensure that the United States does not tax non-U.S. entities more severely than its domestic corporations. The U.S. Congress, however, did not view this as discriminatory because their intent was to equalize the treatment of non-U.S. corporations conducting trade or business in the U.S. with U.S. subsidiary conducting such trade or business. Regardless of Congress' opinion, the U.S. treaty partners believe the branch profits tax rules are an annulment of existing bilateral conventions, which although permissible under U.S. law, constitutes an infraction of international law under Article 27 of the Vienna Convention on the Law of Treaties. See *ibid.* at 797 & note 112.

²²⁴ I.R.C. 884(e)(1) states that: "no treaty between the United States and a foreign country shall exempt any foreign corporation from the tax imposed... unless - (A) such treaty is an income tax treaty, and (B) such foreign corporation is a qualified resident of such foreign country." A corporation is a qualified resident if it meets one of the tests in section 884(e)(4). These tests include:

1. A maximum 50 percent foreign ownership test or 50 percent base erosion test.
2. The stock of company, or stock of its parent company, is primarily and regularly traded on an established securities market.
3. A non-U.S. corporation that is engaged in active conduct of business in a residence-country, has a substantial presence in residence-country, and notwithstanding the exception for interest received, the U.S. business is an integral part of an active business conducted in the residence-country.
4. A ruling by the Secretary of the U.S. Treasury that the corporation is a qualified resident.

²²⁵ IRC section 11.

provisions and served as the framework for future U.S. bilateral tax treaties.²²⁶ The pressure placed on the U.S. Congress to control unmanageable budget deficits and to increase tax revenues were the principal reason for enacting the branch profits tax provisions.²²⁷

The second component of the U.S. attack on treaty shopping began in 1962 with the U.S.-Luxembourg Treaty.²²⁸ Since that time the Treasury Department has attempted to control treaty shopping through the inclusion of specific anti-treaty shopping articles in U.S. tax treaties.²²⁹ The anti-treaty shopping provision in the U.S.-Luxembourg Treaty, Article 15, prohibits the granting of treaty benefits to income entitled to special treatment under Luxembourg laws. In 1970, the Treasury Department in the U.S.-Finland Tax Treaty fabricated a more effective and sophisticated anti-treaty shopping provision.²³⁰ Article 27 of the U.S.-Finland Treaty, entitled "Investment or Holding Companies," refined the provision in the Luxembourg treaty by denying benefits based on a special measures test and a foreign ownership test.²³¹ The special measures test provided that treaty benefits would not be granted if domestic laws taxed the income at rates lower than business profits normally would be taxed and the foreign ownership test denied benefits where non-residents owned a substantial percentage of the interests in an entity. This two-part rule, incorporated into most bilateral treaties negotiated in the 1970's, had a significant impact on the drafting of the first U.S. Model Treaty.²³²

In 1977, the United States drafted its first Model Treaty, which was intended to be a starting point for future treaty negotiations. Article 16 of this model contained an "Investment or Holding Companies" provision, similar to the two-part rule in the U.S.-

²²⁶ See *supra* note 204 at 795.

²²⁷ Richard L. Doernberg, *Legislative Override of Income Tax Treaties: The Branch Profits Tax and Congressional Arrogation of Authority*, 42 Tax Law. 173, 173 (1989).

²²⁸ United States and Luxembourg Convention with Respect to Taxes on Income and Property, December 18, 1962.

²²⁹ See *supra* note 200 at 630.

²³⁰ United States and Finland Convention with Respect to Taxes on Income and Property, March 6, 1970.

²³¹ See *supra* note 204 at 790.

²³² *Ibid.*

Finland Treaty. In 1981, the U.S. Treasury Department published a revision to its Model Tax Treaty that contained a LOB article.²³³ As with previous treaties, entities were required to meet both the foreign ownership standard and a special measures test. The foreign ownership test was modified by adding a safe harbour that deemed resident ownership if a company's stock was publicly traded on a recognized stock exchange. The special measures test was also revised and renamed the conduit rule, or as it is now known, the ownership and base erosion test. This test was significantly more effective than its predecessor as the new test examined the ownership of an entity and the level of payments made to non-treaty residents.²³⁴ In addition, 1981 Model introduced a potential defense for taxpayers who could demonstrate that the principal purpose of their operations was not to obtain of treaty benefits.

From the date of publication of the Model Tax Treaty, U.S. tax treaty policy has zealously pursued the inclusion of LOB provisions designed to prevent treaty shopping in all its newly concluded or renegotiated tax treaties.²³⁵ In a 1990 interview, the international tax counsel at the U.S. Treasury Department stated that the Treasury Department's policy is that every treaty should have an anti-treaty shopping article.²³⁶ Consequently, although negotiations concerning the Protocol arose at the behest of Canada as a result of changes to U.S. estate laws, the international tax counsel at the time stated that treaty shopping would be a centerpiece of Protocol negotiations.²³⁷

²³³ United States, Treasury Department, Draft Model Income Tax Treaty, June 16, 1981; Article 16.

²³⁴ See *supra* note 204 at 791.

²³⁵ Allan R. Lanthier, *Canada-U.S. Protocol Alive*, 2/5 Canadian Tax Highlights 33, 34 (1994).

²³⁶ *One Treaty at a Time, says International Tax Counsel. Interview with Philip D. Morrison, the International Tax Counsel at the U.S. Department of the Treasury*, 1 J. of Int'l Tax 40 (1990). Similarly, in 1996 at the 14th annual International Tax Conference, deputy international tax counsel, Carol Doran Klein, reiterated the Treasury Department's policy that treaties with outmoded LOB provisions or inadequate exchange of information provisions are targeted for negotiation. She stated that "[w]e cannot, and will not, tolerate continuation of treaties that no longer implement important U.S. tax policy and whose continued existence creates a hole in the fabric of that policy." Susan M. Lyons, *U.S. Government Officials Address International Tax Issues*, 12 Tax Notes Int'l 389 (Feb. 05, 1996).

²³⁷ *Ibid.*

In 1990 the U.S. and Germany signed the U.S.–Federal Republic of Germany Treaty.²³⁸ This treaty was based predominately on the 1981 U.S. Model and the OECD Model, and was expected to be a model for future negotiations.²³⁹ The branch profits tax rule’s “qualified residence” requirement influenced the LOB provision contained in Article 28 of the U.S.–Germany Treaty.²⁴⁰ This provision, as the one in the Protocol, limits tax treaty benefits to intended recipients and prevents their extension to non-residents who cannot establish a sufficient nexus the other contracting state.²⁴¹

The LOB article in the U.S.–Germany Treaty was instrumental in the subsequent U.S.–Netherlands negotiations. The Netherlands, grasping the formidable implications of an impending U.S. unilateral override of the 1948 U.S.–Netherlands Treaty, revitalized negotiations, that had stalled for eight years, towards a new tax accord.²⁴² However, the Netherlands government refused to agree to the rigorous conditions in Article 28 of the U.S.–Germany Treaty. The Netherlands desired a treaty that recognized its international economy. The U.S. on the other hand, would not sign a tax treaty that did not explicitly restrict treaty shopping. The incompatible U.S. and Netherlands policies required a

²³⁸ United States and Germany Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital and to Certain Other Taxes, August 29, 1989.

²³⁹ See *supra* note 204 at 798.

²⁴⁰ *Ibid.*

²⁴¹ The first of the four paragraphs of Article 28 contain residency tests, satisfaction of any one of which entitles the taxpayer to treaty benefits. An entity, other than a party who automatically qualifies, is not entitled to the benefits under the U.S.–German Treaty unless that entity satisfies either an active business test, an ownership and base erosion test, or a public company test. Unlike the 1981 U.S. Model Treaty and the U.S.–Finland Treaty, an entity that fails to meet any of the tests can still seek recourse via a determination of the competent authority of the State in which the income in question arises. Although, a considerable advancement in LOB provisions, Article 28 created a controversy over whether the U.S.–German Treaty conflicts with the Treaty of Rome. Treaty Establishing the European Economic Community, Mar. 25, 1957, 1973 Gr. Brit. T.S. No. 1 (Cmd. 5179–II), art. 67, 1, 298 U.N.T.S. 3, 42 (1958)(on February 7, 1992, the twelve member states of the European Community signed the Treaty on European Union, in Maastricht, The Netherlands. Treaty on European Union, Feb. 7, 1992, [1992] 1 C.M.L.R. 719, reprinted in 31 I.L.M. 247 (1992)). An action for breach of the Treaty of Rome may exist because contrary to Article 67 of the Treaty of Rome, which prohibits discriminatory treatment based on the nationality of members, U.S.–German treaty benefits are denied to European Community members on the basis of their nationality. The U.S.–Germany Memorandum of Understanding and the U.S. Senate Report on the U.S.–German Treaty attempted to mitigate German concerns over conflicts involving a potential breach of the Treaty of Rome, and an eventual override by U.S. legislation. See Understanding Regarding the Scope of the Limitation on Benefits Article in the Convention Between the Federal Republic of Germany and the United States of America, S. Treaty Doc. No. 10, 101st Cong., 2d Sess. 3 (1990). For further discussion of this issue see *supra* note 204 at 801. Article 28 of the U.S.–German Tax Treaty is reproduced in Appendix Three.

²⁴² See *supra* note 204 at 801.

sophisticated but workable LOB provision.²⁴³ American and Dutch negotiators adopted the German LOB provision, liberalizing and augmenting its requirements. The ensuing LOB provision vastly exceeded its predecessors, and descendants, in both complexity and length. Although the LOB article in the U.S.–Netherlands Treaty has been criticized, it is notable for its recognition of the Netherlands' EC membership and the Netherlands' economic concerns as an international financing center, as well as U.S. efforts to combat treaty shopping.²⁴⁴

The U.S.–Netherlands Treaty forces non-qualifying persons to either restructure their Dutch operations or relinquish previously granted relief under the 1948 Treaty. Treaty benefits are allowed under the Convention if the resident is an individual, a Contracting State, a political subdivision, a local authority, or if the resident is a not-for-profit tax exempt organization that also satisfies an ownership test.²⁴⁵ The remaining entities, including Dutch holding companies, must either: (1) satisfy a publicly traded test;²⁴⁶ (2) satisfy a test for subsidiaries of public companies;²⁴⁷ (3) hold more than a fifty percent ownership stake and satisfy a base erosion test;²⁴⁸ (4) conduct an active trade or

²⁴³ *Ibid.* at 816.

²⁴⁴ *Ibid.* The U.S. concluded the U.S.–Mexico Tax Treaty on September, 18, 1992. The LOB in the Mexico Treaty is also notable for making compromises by recognizing Mexico's unique status a major U.S. trading partner and Mexico's membership in NAFTA. The Mexico Treaty will not be discussed in this section as the LOB provision in the Netherlands Treaty came later in time and includes far more concessions and trade-offs. However, the LOB provision in the Mexico Treaty will be thoroughly discussed later in the section dealing with amending the LOB Article in the Protocol.

²⁴⁵ The LOB Article in the U.S.–Netherlands Treaty is reproduced in Appendix Four.

²⁴⁶ Cognizant of the participation of the Netherlands in the EC, the U.S.–Dutch Memorandum of Understanding adds the stock exchanges of Frankfurt, London, and Paris to the list of permissible stock exchanges under subparagraph 8(d)(iv) of Article 26. Understanding Regarding the 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, Dec. 18, 1992, reprinted in 2 Tax Treaties (CCH) 6113, at 36,443. Arguably the most profound achievement of the Convention is its explicit, though regrettably incomplete, recognition of the Dutch membership in the EC. See *supra* note 204 at 818.

²⁴⁷ This relaxed test presents a two-part analysis that hinders clearly abusive situations. The first part applies to both Dutch and U.S. subsidiaries of publicly traded companies. The initial determination examines whether more than fifty percent of a subsidiary's stock is owned by five or fewer companies with residency in either the United States or the Netherlands. The second test, unique to this anti-treaty shopping provision, applies only to Dutch corporations and addresses Dutch membership in the EC. Ownership of the subsidiary by residents of the Netherlands must equal at least thirty percent. Further, seventy percent or more of the aggregate vote and value of all shares must be controlled by residents of the United States or by EC members.

business,²⁴⁹ or (5) satisfy a headquarters test.²⁵⁰ If entities fail the above tests they can attempt to qualify under a derivative benefits test.²⁵¹ Finally, if all else fails entities that conclude they should be entitled to treaty benefits, but do not qualify under any of the above tests, can apply for a determination by the competent authority that they are entitled to treaty benefits.²⁵²

²⁴⁸ While leaving the ownership test virtually unchanged, the base erosion test receives three significant additions. First, in recognition of the increasing unity in the EC, the test permits a resident of the Netherlands to make deductible payments of less than seventy percent of gross income to non-qualified persons. However, if these payments are not made to qualified residents nor citizens of the EC, the distribution must be less than thirty percent of gross income. Second, the applicable gross income constitutes the greater of the gross income from the previous year or the average gross income over the previous four years. The final, and perhaps most notable, modification is that the deductible payments do not include arm's length payments for either the right to use tangible property in the ordinary course of business or remuneration at arm's length for services performed in the payer's country.

²⁴⁹ Whether the income recipient's trade or business is substantial will be determined by analyzing the proportionate share of the activity in the source-country, the nature of the activities performed, and the relative contributions made in both countries. An entity can include business conducted in other EC nations, if its Dutch activity exceeds fifteen percent of its EC operation's assets, gross income, and payroll ratios.

²⁵⁰ The innovative headquarters test was drafted specifically to prevent an exodus of the international companies located in the Netherlands. A company with headquarters in the Netherlands will qualify if it provides both independent discretionary authority and a substantial part of the overall supervision and administration of operations in at least five countries. The headquarters cannot receive more than twenty-five percent of its gross income from the other Contracting State. Furthermore, the business activities carried on in any country, other than the country of residence of the headquarters company, must generate less than fifty percent of the gross income of the group.

²⁵¹ Uncharacteristic of past U.S. tax treaties, the U.S.-Netherlands Treaty includes a derivative benefits provision. A Dutch company, controlled by a third-country resident, will be entitled to treaty benefits for a particular payment of income if equivalent treaty benefits for that distribution exist between the United States and the third-country. This narrow test applies only to dividends, branch tax, interest, and royalty items of Dutch companies. In addition, more than thirty percent of the aggregate vote and value of all shares must belong to qualified residents of the Netherlands, and more than seventy percent must belong to EC members. Finally, the company must satisfy the base reduction test described in paragraph 5 of Article 26.

²⁵² Articles 19, 20, and 21 of the U.S.-Dutch MOU enumerate relevant factors for the tax authorities to consider when determining whether to grant benefits of the Convention. Article 19 details six factors to be used by the competent authority when determining whether the establishment, acquisition, or maintenance of a corporation has or had as one of its principal purposes the obtaining of benefits under the Convention. These factors evaluate the length, purpose, and legitimacy of the operations in the recipient country. In addition, Article 21 of the U.S.-Dutch MOU accounts for the membership of the Netherlands in the EC by allowing the competent tax authority to evaluate changes in circumstances that disqualify a company from obtaining treaty benefits.

The six factors are: (1) the date of incorporation of the corporation in relation to the date that this Convention entered into force; (2) the continuity of the historical business and ownership of the corporation; (3) the business reasons for the corporation residing in its State of residence; (4) the extent to which the corporation is claiming special tax benefits in its country of residence; (5) the extent to which the corporation's business activity in the other State is dependent on the capital, assets, or personnel of the corporation in its State of residence; and (6) the extent to which the corporation would be entitled to treaty benefits comparable to those afforded by this Convention if it had been incorporated in the country of residence of the majority of its shareholders. U.S.-Netherlands Memorandum of Understanding, Article XIX, 2 Tax Treaties (CCH) 6113, at 36,442-43.

However, it should be noted that, regardless of the Netherlands' LOB article's significance, it can be readily discerned by a brief overview of its provisions that the complexity its tests will require sophisticated technical advice. This guidance will signify increased costs for taxpayers.²⁵³ Additionally, it should also be observed that its eventual effectiveness, in terms of preventing treaty shopping while not effecting *bona fide* transactions, depends on how its tests are interpreted by the respective competent tax authorities.²⁵⁴

The U.S. Reasons for Insisting on the Inclusion of the LOB Article in the Third Protocol:

While the Convention prior to the Third Protocol did not have a specific anti-treaty shopping article on the scale of the LOB, it did have a limited provision in the form of Article XXIX subparagraph 6.²⁵⁵ This subparagraph declared Articles VI to XXIV inapplicable to NROs. Further, subparagraph 6 declared those Articles inapplicable to profits, income or capital gains derived by a trust if its principal purpose for establishment was to obtain treaty benefits. Since subparagraph 6 was not a full blown LOB provision, it was too limited in scope to satisfy the U.S. desire to stop treaty shopping and it was

²⁵³ See *supra* note 204 at 819.

²⁵⁴ Several U.K. companies, not engaged in treaty shopping, may be adversely impacted by the U.S.-Netherlands Treaty. In the United Kingdom, companies are prohibited from obtaining the maximum foreign tax credit on taxes assessed on distributions of their subsidiary's dividends. U.K. companies may obtain lost foreign tax credit benefits by establishing a mixing company in the Netherlands. A mixing company permits dividends from different sources to flow into the Dutch holding company, thus enabling the U.K. parent company to receive dividends from a single non-U.K. company. Though this practice was permissible under the 1948 Treaty, the U.K. mixing company will likely fail the objective tests under Article 26 and be forced to seek an affirmative ruling from a competent tax authority. If a U.K. mixing company is denied benefits under the U.S.-Netherlands Treaty, it will face a severe increase in its tax burden. See *supra* note 204 at 820-21.

However, the assistant chief counsel international of the IRS, Christine Halphen, stated that the mixing company structure is not a typical treaty shopping structure because its purpose is not to gain treaty. If the company had been set up between the U.K. and the U.S. it would have received the same withholding rates under the U.S.-U.K. tax treaty. The IRS has determined that the derivative benefits test can be expanded beyond its mechanical requirements so that a favourable competent authority ruling can be given to these companies. To receive a favourable ruling the mixing company must demonstrate to the IRS that it does not erode the tax base in the Netherlands and that the parent company itself would qualify for treaty benefits in its country of jurisdiction. Marianne Kennedy and Angelo Nikolakakis, *Canada-U.S. Cross-border Issues*, Report of the Proceedings of the Forty-Sixth Tax Conference of the Canadian Tax Foundation (1994 Conference Report) at footnote 21.

²⁵⁵ Under the Protocol Article XXIX(6) has been deleted and replaced by Article XXIX A.

predictable that the U.S. would insist on including one in the Protocol.²⁵⁶ However, as will be discussed below²⁵⁷ there are several superior, and less potentially harmful, alternatives that could have been incorporated in the Protocol instead of the LOB Article.

Normally, conduit companies involved in treaty shopping are located in countries with low tax rates or in tax havens. This practice has led commentators to question why the U.S. would insist on including a LOB provision in the Protocol when Canada is considered an unattractive location for conduit companies as a result of its system of worldwide taxation and relatively high tax rates.²⁵⁸ To support its demand for the inclusion of the LOB Article, the U.S. made the astonishing argument that Canada *is a popular tax haven* base for many third-world investments.²⁵⁹

As unbelievable as the U.S. argument is, the Canadian tax system does, in fact, provide several benefits to international investors. For example, a third country foreign investor's overall tax liability can be reduced by using Canada as a stepping stone for cross-border investment. This can occur because the taxation of foreign earnings under the exemption system, whereby dividends paid by a foreign affiliate of a corporation resident in Canada become exempt from Canadian taxation if the income is paid out of exempt surplus. This system can be used to the advantage of a foreign multinational by having its Canadian subsidiary hold the shares of its other foreign subsidiaries so that dividends are paid out of exempt surplus and are not be subject to Canadian tax.²⁶⁰ Additionally, taxation can be further deferred if, instead of paying a dividend to its foreign parent, the Canadian subsidiary reinvests the dividends in the other subsidiaries.²⁶¹

²⁵⁶ See *supra* note 16.

²⁵⁷ See the section entitled Alternatives and Future Amendments to the Limitation on Benefits Provision.

²⁵⁸ See *supra* note 16 at 968.

²⁵⁹ See *supra* note 47 at 35, 36. Canada in fact was a tax haven base for many third-country investments prior to 1972. *Ibid.* at 36. Prior to the 1972 tax reform, many international corporations used a Canadian intermediary to invest in other jurisdictions. This was because Canada did not tax income accumulated in foreign affiliates, and if the Canadian corporation held more than 25 percent of the voting rights the income could be received in Canada tax free. See *supra* note 42 at 74. However time marches on. The reforms introduced in 1972 eliminated the utility of treaty shopping through Canada. *Ibid.* at 42 note 3.

²⁶⁰ See *supra* note 16 at 968.

²⁶¹ *Ibid.*

However, Russell and Boidman both separately concluded that the limited benefits the Canadian tax system may provide treaty shoppers was not the primary concern of U.S. treaty negotiators.²⁶² They were more concerned with maintaining their existing policy of including a LOB article in every tax treaty and they were also worried that the Protocol would not be ratified by the U.S. Senate if the Protocol did not include a LOB article in accordance with established policy.²⁶³ Additionally, they were probably influenced by the belief that an exemption for Canada would have weakened the U.S. bargaining power with its other treaty partners.²⁶⁴ Finally, they were undoubtedly concerned that if the Protocol did not have a LOB article then residents of countries which had negotiated a treaty with the U.S. that did have a LOB article could use the Canada-U.S. treaty to obtain treaty benefits that were not otherwise available.²⁶⁵

Canada's Reasons for Acquiescing to the Inclusion of the LOB Article in the Protocol:

The LOB provision is not reciprocal. It can only be applied by the U.S. to determine whether a Canadian resident is entitled to treaty benefits. It is not Canadian tax treaty policy to include specific provisions that limit treaty shopping.²⁶⁶ In fact the term treaty shopping is not used in Canadian tax legislation, tax treaties or court decisions.²⁶⁷ Additionally, treaty shopping is not generally considered improper or a misuse of a treaty unless the treaty specifically provides for this.²⁶⁸ Canada is generally more concerned with an erosion of its tax base through improper transfer pricing and the use of related entities in tax havens causing an undue or artificial reduction of tax.²⁶⁹

²⁶² *Ibid.* and see *supra* note 13.

²⁶³ See *supra* note 16 at 969.

²⁶⁴ *Ibid.*

²⁶⁵ *Ibid.*

²⁶⁶ *Ibid.* at 965.

²⁶⁷ See *supra* note 42 at 73.

²⁶⁸ *Ibid.* at 77.

²⁶⁹ *Ibid.*

Rather than relying on the LOB provision, at Canada's request paragraph 7 of the LOB Article gives both Canada and the U.S. the power to deny treaty benefits when to do otherwise would result in an abuse of the provisions of the treaty.²⁷⁰ Canadian tax treaty policy focuses on the "abuse of treaty" approach to withhold treaty benefits, where it reasonably can be concluded that to do otherwise would result in an abuse of the provisions of the Convention.²⁷¹ At the 46th Tax Conference the assistant deputy minister, Tax Policy Branch, of the Department of Finance, Mr. Dancey, stated that Canadian authorities were unwilling to subscribe to a set of mechanical rules, which they felt would not be effective at distinguishing between abusive and non-abusive situations.²⁷² Additionally, he stated that Canadian authorities were concerned that since the LOB rules apply only for the purposes of the application of the Convention by the U.S., taxpayers might infer that situations that would be caught by the LOB rules, if applied by Canada, would be acceptable for Canadian purposes, and moreover, that benefits could not be denied where the LOB rules did not apply.²⁷³ Thus paragraph 7 was included in the LOB Article to specifically prevent such inferences. Mr. Dancey further stated that paragraph 7 should not be interpreted as restricting or expanding either Canada's or the U.S. ability to deal with abusive situations.²⁷⁴ In this regard the assistant U.S. Treasury Department international tax counsel stated that the LOB article does not prevent the U.S. from applying its anti-avoidance rules or recharacterizing a transaction in accordance with its economic substance.²⁷⁵ Thus under paragraph 7, the U.S. can apply the provisions in the LOB Article and its domestic anti-abuse rules while Canada is limited to its anti-abuse rules.

The non-reciprocal nature of the LOB Article raises the question of why Canada would agree to the inclusion of a treaty provision that does not fit within Canadian tax

²⁷⁰ See Appendix One; Third Protocol, Article 18(7) and note 16 at 965.

²⁷¹ See Tax Foundation Report *supra* note 254 at 24:14.

²⁷² *Ibid.* at 24:14–24:15.

²⁷³ *Ibid.* at 24:15.

²⁷⁴ *Ibid.*

²⁷⁵ *Ibid.*

treaty policy and which can potentially harm Canadian resident entities and Canadian tax revenue? One central reason is that failure to co-operate in tax treaty negotiations may persuade the U.S. to unilaterally cancel the treaty, as it did with the British Virgin Islands in 1982, the Netherlands Antilles in 1987 and recently Malta in 1995.²⁷⁶ In February 1981 the U.S. signed a new treaty with the British Virgin Islands (B.V.I.) to replace the former extension to the B.V.I. of the U.S.-U.K. Tax Treaty. Before the Treaty was ratified, the U.S. tried to include an anti-treaty shopping clause but the B.V.I. refused. The U.S. terminated the Treaty effective January 1, 1983.²⁷⁷ Similarly, the Netherlands resisted U.S. attempts to revise the 1948 U.S.-Netherlands Tax Treaty, as it applied to the Netherlands Antilles. Netherlands Antilles was a favoured location for international businesses and investments because of its extensive bilateral tax treaty network, which was not subject to anti-treaty shopping provisions. However, as result of the Netherlands refusal, on June 29, 1987, the U.S. Treasury Department unilaterally terminated the treaty as it applied to the Netherlands Antilles.²⁷⁸ Recently, the U.S. terminated its tax treaty with Malta because Malta refused to accede to a LOB provision.²⁷⁹ These incidents illustrate the growing unilateralism in U.S. foreign tax policy, a policy that confirms a growing intolerance among both the executive and legislative branches toward treaty shopping of any sort. These policies most likely created apprehension and concern in

²⁷⁶ See *supra* note 204 at 778 note 13.

²⁷⁷ See *supra* note 47 at 35.

²⁷⁸ See *supra* note 22 at 362. The immediate cost of terminating the treaty was a negative effect on the international bond market. Prior to the termination of the treaty U.S. corporations set up finance subsidiaries in the Netherlands-Antilles from which the issued bonds which were free from U.S. withholding tax as a result of Article VIII of the treaty and which were free from domestic tax since the Netherlands Antilles did not tax payments made to foreign investors. Essentially, U.S. corporations used the Netherlands Antilles as a conduit to raise money for financing cheaply. When the Treaty was terminated the international bond market was upset since bonds issued by the subsidiaries of U.S. corporations were now subject to a 30 percent withholding tax. Also, the majority of the bonds were redeemed at par value, whereas before they were trading at a premium, since the terms of most bonds included a call provision in case a withholding tax was imposed. Issuers thus made a windfall since they were able to refinance loans at a discount and investors bore the loss. The Netherlands Antilles economy also suffered negatively. One of the major blows the Netherlands Antilles economy suffered as a result of the Treaty's termination was that real estate investment companies became subject to branch profits taxation. In December 1992, the Netherlands seceded its status as a favorite conduit location when it signed the new U.S.-Netherlands Protocol that included a LOB provision. *Ibid.* at 356-57, 380.

²⁷⁹ Dianne Bennett, *Third Protocol to the Canada-U.S. Tax Treaty*, Report of the Proceedings of the Forty-Seventh Tax Conference, 1995 Conference Report 44:1, 44:19 (1995).

Canadian negotiators, and caused them to unwillingly agree to the inclusion of the LOB Article in the Protocol.

Even if the close economic association and amicable relations between Canada and the U.S. make it unlikely that the U.S. would unilaterally cancel the Convention, the changes Canada desired in Convention regarding estate and death taxes may have been incentive enough for Canada to agree to the LOB Article in the Protocol.²⁸⁰ Particularly, if, as I suspect, U.S. negotiators utterly refused to agree to the inclusion of the favourable estate and death tax changes Canada desired unless Canada correspondingly agreed to the inclusion of the LOB Article. Nonetheless, I believe that U.S. negotiators would never agree to a Protocol that did not include some form of a LOB Article. Thus, Canadian negotiators most likely had no choice but to acquiesce to the U.S. firm demands. Therefore, the issue is not whether Canada should have agreed to the LOB Article in the Protocol, but what formulation of the LOB Article should Canada have agreed to?

²⁸⁰ See text accompanying notes 135-159 discussing the changes resulting from the Protocol in the estate and death taxes Canadians with U.S. property are subject to in the U.S. These taxes increased after the U.S. 1986 Tax Reform Act, prompting Canada to seek changes to the Convention.

THE LIMITATION ON BENEFIT ARTICLE IN THE THIRD PROTOCOL:

In my opinion, the LOB Article can be summarized by the four following quotations.²⁸¹

In this world, nothing is certain but death and taxes.

Benjamin Franklin, 1789

At least death doesn't keep getting worse every year.

Charlie Farquharson, 1972

There is nothing so difficult as the income tax.

Albert Einstein.

The new legislation is more complex than anything ever seen before in this country, a complexity that aids tax collection and harms taxpayers.

Arthur Drache,

Financial Post Tax Specialist commenting on 1988 Canadian Tax Reform.

The 1980 Convention contained limited anti-treaty-shopping rules that denied treaty benefits to NROs deriving U.S. source income and certain trusts or estates. "However, the United States felt compelled to incorporate in the Protocol a full-blown set of anti-treaty-shopping rules, *as if* the Canadian tax system provided a wide range of opportunities for third-country investors in the United States to reduce their overall tax liability by using Canada as a stepping-stone to realize and extract U.S.-source income."²⁸²

In this Chapter, I shall begin my detailed analysis of the LOB Article in the Protocol. I shall examine the LOB Article in detail. First, bearing in mind that the Article contains several undefined and vague terms, I shall discuss how the Article will likely be interpreted and applied. Second, I shall analyze the three component parts of the Article:

²⁸¹ These four quotations are from Evelyn Jacks, *Jacks on Tax Savings*, (12th ed. 1996), reproduced in Quick Tax Deluxe: Tax Year 1995, Tax Preparation CD-ROM (1995).

²⁸² See *supra* note 13, *emphasis added*.

(1) the qualifying person tests; (2) the exceptions to the qualifying person tests; and (3) the general anti-abuse provision. When analyzing the qualifying person tests and its exceptions, I shall discuss the potential problems they present for Canadian entities. Additionally, in discussing these tests I shall review any tax planning consideration that tax practitioners should keep in mind when advising their clients. Third, I shall continue this chapter by discussing how Canadian resident taxpayers, as a result of failing to qualify under the LOB Article, will be impacted by the denial of treaty benefits. I shall conclude my analysis of the LOB Article by discussing its possible impact on Canadian tax revenue.

As discussed in the U.S. tax treaty policy chapter, the U.S. is concerned about persons planning their affairs to obtain treaty benefits for which they are not otherwise eligible. Hence, the U.S. insists on bilateral tax treaties that attempt to prevent treaty shopping through the use of intricate anti-treaty shopping provisions. Canada, on the other hand, does not hold this same concern and generally, as discussed, does not include detailed anti-treaty shopping provisions in its tax treaties.²⁸³

Prevailing tax treaty policy dictates that treaty benefits should be available to individuals, corporations and other entities that are residents of treaty contracting states.²⁸⁴ Consequently, prior to the Protocol the Convention did not include a detailed general provision against treaty shopping. However, upon the insistence of the U.S. the Protocol added a new, and controversial, LOB provision, Article XXIX A, to the Convention.²⁸⁵ This Article is intended to eliminate the problem of treaty shopping by requiring an entity seeking treaty benefits in the U.S. not only be a Canadian resident but also satisfy additional tests that demonstrate that their residence in Canada is not considered to have been motivated by the existence of the Convention. Essentially, the LOB Article provides “qualified persons” with all of the benefits of the Convention, while non-qualified persons

²⁸³ See *supra* note 112 at 56. Revenue Canada is of the view that the general anti-avoidance rule can be applied to deny treaty benefits. *Changes to the Canada-U.S. Treaty*, 5 Canadian Current Tax 27, 28 (December 1994).

²⁸⁴ See *supra* note 20 at 43.

²⁸⁵ See Appendix One; Third Protocol, Article 18. The provision is applicable only by the U.S. to determine if treaty benefits will apply to taxation of Canadian residents. See *Changes supra* note 112 at 27, 28. While the LOB provision can only be applied by the United States, Canada can deny treaty benefits if it concludes that the provisions of the treaty are being abused.

are entitled to none of its benefits.²⁸⁶ Prior to the LOB Article, a Canadian entity was entitled to U.S. benefits under the Convention as a mere resident of Canada. Naturally, a determination of who falls within the definition of a qualified person is vital.²⁸⁷ If a person is not a qualifying person treaty benefits may still be obtained if the person satisfies the “active business” test, the “derivatives benefits” test or is granted relief by the U.S. competent authority.

It should be noted that the LOB Article in Article XXIX A is not reciprocal except for paragraph 7. Canada prefers to rely on its general anti-avoidance rule to counter arrangements involving treaty shopping through the United States.²⁸⁸ Under paragraph 7 general anti-abuse provisions are applicable by both the United States, in addition to the LOB Article, and Canada.²⁸⁹ However, the general anti-abuse rules are distinguishable in their application. While the LOB Article determines whether a person has a sufficient nexus to Canada to be entitled to treaty benefits, the general anti-abuse provisions determine whether a particular transaction should be recast in accordance with the substance of the transaction.²⁹⁰

The purpose and design behind the LOB Article, the elimination of *the problem* of treaty shopping between Canada and the U.S., necessitates the obvious query – is there a problem of treaty shopping between Canada and the U.S.? More specifically, are third country residents with U.S. sourced investments utilizing Canadian intermediary entities as conduits for treaty shopping purposes into the U.S.? An affirmative answer to these questions raises the following inquiry – if so, to what extent? Finally, the response to the latter query causes one to ask – does the degree of treaty shopping that occurs between Canada and the U.S., assuming there is any, justify the inclusion of the LOB Article in the Treaty? These questions are the essence of the inquiry in my thesis.

²⁸⁶ See *Changes supra* note 112 at 28.

²⁸⁷ See Gelardi *supra* note 112 at 57.

²⁸⁸ See *supra* note 113, Technical Explanation, Article 18.

²⁸⁹ *Ibid.*

²⁹⁰ *Ibid.*

Interpreting the LOB Article:

Under the LOB Article a Canadian resident can qualify for treaty benefits under a number of objective and subjective tests, or through a subjective determination by U.S. competent authorities. The degree to which treaty benefits will be granted depends on how stringently or leniently these tests are interpreted and applied.²⁹¹ However, a number of the terms in these tests are complex and undefined. As a result, the tests in the LOB Article are vague and uncertain. This vagueness and uncertainty creates the potential of inconsistent interpretations and differing determinations as to appropriateness of granting treaty benefits. The manner in which the LOB Article will be interpreted will be significant as contemporary LOB provisions are of recent origin with only a slight history of application and interpretation. The combination of vague terminology, the lack of adequate definitions and paltry interpretive history creates serious problems for taxpayers as they will be uncertain, unless they satisfy one of the bright line mechanical tests, as to their entitlement to treaty benefits.

As mentioned, the LOB provisions in the Protocol are not reciprocal. Contrary to other U.S. tax treaties, these provisions can only be applied by U.S. competent authorities. As a result of the unilateral U.S. application of the anti-treaty shopping provisions in the Protocol, U.S. domestic tax law must be used to interpret concepts that are not defined by the Protocol or the Convention. Thus, this section shall discuss how the LOB Article will most likely be interpreted by U.S. competent authorities.

The rule for interpreting the Canada-U.S. Tax Treaty is found in Article III(2) of the Convention. This paragraph provides that "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."²⁹² Article III(2) of the Convention

²⁹¹ Michele Gelb, *The Limitation on Benefits Provisions of the United States-Mexico Tax Treaty*, 9 Emory Int'l L. Rev. 217, 227 (1995).

²⁹² As mentioned, the LOB Article can only be applied by the U.S. and U.S. domestic tax law will apply to interpret any term that is not defined in the Convention or Protocol.

mandates a four step process to interpret a vague term in the LOB Article. First, the Convention and its Protocols must be examined to determine if the term is defined therein.²⁹³ Additionally, Canada and the U.S. have agreed that the Technical Explanation accurately reflects understandings reached during negotiations and is authoritative in interpreting the Protocol.²⁹⁴ Therefore, the Technical Explanation must also be examined to determine if it sheds any light on the meaning of the vague term. Second, if the term is not defined in the Convention or its Protocols, it must be determined whether the Canadian and U.S. competent authorities have reached an agreement on the meaning of the term pursuant to Article XXVI (Mutual Agreement Procedure). Third, if the Convention or its Protocols do not define the term and the competent authorities have not agreed on a definition of the term, it must be determined if the context in which the term is used requires an interpretation independent of U.S. domestic tax law. Finally, if a definition cannot be found through the above procedures, the definition of the term will be determined under the U.S. domestic tax law applicable to the taxes that are the subject of the treaty.

The U.S. domestic tax law that is most applicable to the LOB Article, as suggested by U.S. Senate Foreign Relations Committee in connection with the LOB article in the French-U.S. Tax Treaty, is the U.S. branch profits taxation rules and regulations. These rules can be used to interpret the LOB Article as it is based on the branch profits tax rules and the qualifying person test is similar under both provisions.²⁹⁵

Supplementary to the above interpretative process, the U.S. Supreme Court and the Supreme Court of Canada have held that treaties should be liberally construed to give effect to their purpose.²⁹⁶ In the U.S. treaty provisions are interpreted by examining the

²⁹³ This is a relatively easy process as few terms are defined in the Protocol or Convention.

²⁹⁴ See *supra* note 11 at 44.

²⁹⁵ See *supra* note 201 at 35 note 120. I shall not discuss which branch tax profits rules can be used to interpret the LOB Article in this section. I shall leave that discussion to the sections analyzing each individual provision in the Article in order to avoid repetition.

²⁹⁶ See *Bacardi Corporation of America v. Domenech*, 311 U.S. 150, 163 (1940) and *United States v. Stuart*, 489 U.S. 353, 368 (1989). Canadian courts have held that, contrary to an ordinary taxing statute, a tax treaty must be given a liberal interpretation with a view to implementing the true intentions of the parties. *J.N. Gladden Estate v. The Queen*, [1985] 1 C.T.C. 163 (F.C.T.D.), at 166-67. Cited with approval in *Queen v. Crown Forest Industries*

text of the treaty, its protocols, and any technical explanations and/or memorandum of understanding ("MOU"). There is also the view in U.S. jurisprudence that, although not conclusive, the meaning attributed to treaty provisions by government agencies charged with their negotiation and enforcement is entitled to great weight.²⁹⁷

A recent Supreme Court of Canada case on treaty shopping that is relevant, and which Canadian tax practitioners will be familiar with, is *The Queen v. Crown Forest*, in which the U.S. government acted as an interested Intervenor.²⁹⁸ This case is pertinent to the issue of interpreting the Protocol as the U.S. Government's Factum stated that "[a]lthough this Court's decision will not bind U.S. courts, it will be regarded by U.S. taxpayers as an important precedent and may be relied upon by them."²⁹⁹

In *Crown Forest*, the S.C.C. chose to inquire into whether their decision fell within the intention of the drafters of the Convention. Iacobucci J., writing for the Court, stated that he "agree[s] with the Intervenor Government of the United States' submission that, in ascertaining these goals and intentions, a court may refer to extrinsic materials which form part of the legal context ... without the need first to find an ambiguity before turning to these materials."³⁰⁰ The Court, at the urging of the Canadian and U.S. governments, relied extensively on extrinsic materials, specifically the United Nations Model Convention, the Report of the United States Senate Committee on Foreign Relations and the OECD Model Double Taxation Convention on Income and on Capital. The Court stated that OECD commentary was "[o]f high persuasive value in terms of defining the parameters of the... [Convention]"³⁰¹ and that it is an "...international agreement worthy

Limited, 95 D.T.C. 5389 (S.C.C.), at 5396. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated in so far as the particular item under construction is concerned.

²⁹⁷ *Sumitomo Shoji America Inc. v. Avagliano*, 457 U.S. 176, 184-5 (1982). However in the opinion of the American Law Institute ("ALI"), U.S. courts place too much weight on such unilateral interpretative materials. *See supra* note 11 at 27.

²⁹⁸ Morris and Meghji state that it is noteworthy that Court's reasons for judgment had been influenced significantly by the submissions of the U.S. government, which took the same position as the government of Canada. *See infra* note 306 at 12.

²⁹⁹ Factum of the Intervenor, para. 37. *Cited in* note 306 at 12.

³⁰⁰ 95 D.T.C. 5389 (S.C.C.), Iacobucci J., at 5396.

³⁰¹ *Ibid.* at 5398.

of consideration as an extrinsic material.”³⁰² Of specific relevance for our inquiry as to how the Protocol will be interpreted by the U.S., it is notable that the U.S. Government’s Factum stated that “[t]he OECD Model has worldwide recognition as a basic document of reference in the negotiation, application, and interpretation of tax conventions.”³⁰³

The Court’s judgment will have significant ramifications because it confirms that it is appropriate for courts to have regard for the intentions of the drafters of tax conventions and to the general purpose of the convention.³⁰⁴ Additionally, it is important because the Court did not limit the use of extrinsic materials to situations where there was an ambiguity in the text, but used the materials as part of its interpretation tools.³⁰⁵ Thus, *Crown Forest* offers judicial support at the highest level for relying on extrinsic material to aid in the interpretation of tax treaties.³⁰⁶ Further, since the U.S. government argued that extrinsic materials should be used to interpret the Convention in this case, and the fact that they stated that U.S. taxpayers can consider this case important precedent which can be relied upon, it can be inferred that the U.S. would consider it appropriate to utilize extraneous materials as interpretive guides for the LOB Article. In my analysis of the LOB Article I shall utilize such extraneous materials, where applicable, to assist with determining the boundaries of the various vague and undefined terms in the Protocol.

Also of importance in interpreting the LOB Article in the Protocol are Russell and O’Brien’s conclusions that many of terms and tests in the LOB Article are very similar to

³⁰² *Ibid.* Iacobucci J., at 5399. In looking at the goal of tax treaties the court was influenced by their *raison d’être*, the elimination of double taxation and the prevention of fiscal evasion. In its analysis the Court began by inquiring into whom the Convention was intended to benefit. The Court determined that the target group the Convention is intended to benefit is Canadians working in the U.S. (or vice versa) and Canadian companies operating in the U.S. (or vice versa). *Ibid.* at 5396.

In referring to the U.S. Senate Foreign Relations Committee report titled *Tax Conventions and Proposed Protocols with Canada*, the Court stated that the principal purposes of the Canada–U.S. Tax Treaty are the reduction or elimination of double taxation of income earned by citizens and residents of either country from sources within the other country and the prevention of avoidance and evasion of income taxes of the two countries. *Ibid.*

³⁰³ Factum of the Intervenor, para. 18, cited in note 306 at 13.

³⁰⁴ See *supra* note 306 at 13.

³⁰⁵ *Ibid.*

³⁰⁶ D. Bernard Morris and Al Meghji, *What is Residency under the Canada–U.S. Convention?* Supreme Court of Canada Decision in *Crown Forest*, 6/2 Canadian Current Tax 11 (1995).

those in the U.S.–Netherlands Income Tax Treaty’s LOB article and these can be used as interpretive guidelines.³⁰⁷ However, it should be noted that while these interpretations are helpful in predicting how the United States might apply these standards, they are the results of bilateral negotiations and may not be applicable to the unilateral approach that the United States might take with regard to the LOB Article in the Protocol.³⁰⁸

Nonetheless, although the U.S.–Netherlands definitions may not be authoritative precedents, they can be useful as guidelines. Consequently, there is good reason to believe that they may nevertheless still be more instructive than U.S. domestic tax law because of the similarity of the language in the LOB provisions found in U.S. tax treaties, which makes an analysis of these similar tax treaties beneficial.³⁰⁹ The American Law Institute (“ALI”) has also stated that it is appropriate to look at the interpretation of other similar treaties, including their technical explanations and the U.S. courts’ interpretations, when interpreting treaty provisions.³¹⁰ Hence, comparing the two provisions and examining the literature concerning in the LOB provision Netherlands treaty, as well as its impact on the Netherlands, will be useful in interpreting the LOB provision in the Protocol and analyzing its potential impact in Canada.³¹¹

Analysis:

Prior to the Protocol, the Convention contained a limited anti–treaty shopping provision in the form of paragraph 6 of Article XXIX. The Protocol removes paragraph 6 of Article XXIX and replaces it with Article XXIX A, the LOB Article. Under the previous provision any person who was a resident of Canada was entitled to Treaty

³⁰⁷ U.S.–Netherlands Income Tax Treaty, Article 26. *See supra* note 16 at 970 and note 345.

³⁰⁸ *See supra* note 633 at 246–47. The U.S.–Netherlands LOB Article is accompanied with numerous definitions for terms that are ambiguous in the Protocol. The absence of specific definitions in the Protocol may indicate a lack of agreement during the negotiations or an agreement that the terms would be ascribed meanings the U.S. would apply in its domestic tax law. *See supra* note 20 at 45. Thus, since Canada and the U.S. have agreed that the Technical Explanation accurately reflects under standings reached during negotiations it is more authoritative, even though it is less precise. *See supra* note 11 at 44.

³⁰⁹ *See supra* note 633 at 246–47..

³¹⁰ *See supra* note 11 at 44.

³¹¹ *Ibid.*

benefits.³¹² For example, a company incorporated in Canada, owned and operated by a resident of the Cayman Islands, and doing business in the U.S. would prior to the Protocol be entitled to treaty benefits under the Convention.³¹³ Under the LOB Article in the Protocol, which the U.S. has gone to great lengths to include in all their tax treaties, a resident of Canada is not entitled to treaty benefits from the United States unless they are a so-called “qualifying person,” or they satisfy an active business test, a derivative benefits test, or the U.S. competent authority decides to grant them treaty benefits.³¹⁴

Denying treaty benefits in situations such as treaty shopping through Canada into the U.S. by residents of the Cayman Islands treaty is appropriate. However, LOB Articles, such as those in the Protocol, have been subject to intense scrutiny because they may apply in situations where there is no intent to, nor resulting treaty shopping, and consequently no tax treaty abuse.³¹⁵

One of the primary arguments I am advancing in my thesis is that the LOB Article frustrates the utility of the beneficial changes brought about by the Protocol, as it denies treaty benefits to certain Canadian resident corporations and trusts that prior to the Protocol were entitled to benefits. The goal of this Article is to reduce treaty shopping by preventing non-treaty parties from obtaining treaty benefits. Treaty benefits are now limited only to qualifying persons and those that fall within one of the limited exceptions.³¹⁶ However, while the intent of the LOB Article is to reduce treaty shopping, it may have an adverse impact upon Canadians not engaged in this activity. This Article has the potential to deny benefits to entities that are wholly Canadian owned and engaged in *bona fide* non-treaty shopping activities, but unfortunately fail to qualify under one of the LOB Article’s complex tests. Where treaty benefits are denied, these Canadian corporations and trusts will be subject to a doubling or tripling of the withholding tax

³¹² See Article I of the Convention.

³¹³ See *supra* note 20 at 44. This is the classic form of treaty shopping, the stepping stone structure, that the U.S. is interested in preventing.

³¹⁴ See *supra* note 91.

³¹⁵ See *supra* note 20 at 45.

³¹⁶ See *supra* note 47 at 35.

imposed on their U.S. source income.³¹⁷ Moreover, the LOB Article is a problem for Canadian taxpayers engaged in cross-border trade and investment as it introduces a new level of complexity and uncertainty which they must contend with.

Before discussing the details of the LOB Article, I would like to present two examples that demonstrate the interaction of the its numerous provisions. At the 46th Tax Conference, Ms. Dunahoo, the U.S. Treasury Department associate international tax counsel, presented the following examples to illustrate the application of the LOB Article.³¹⁸

The first example considered the takeover of a Canadian parent corporation (Canco) in three separate scenarios: first, by a 'U.S. public corporation' (USco); second, by a 'foreign corporation resident in a treaty jurisdiction' (Trco); and finally, by a 'non-treaty corporation' (Ntrco). By way of introduction, Ms. Dunahoo considered Canco's entitlement to treaty benefits before any of the takeovers. Prior to the takeover Canco would be entitled to treaty benefits if: (1) its shares were substantially and regularly traded on a recognized exchange; or (2) if it was more than 50 percent owned, directly or indirectly, by five or fewer companies or trusts traded on a recognized stock exchange, if each of the companies or trusts were a qualifying resident or U.S. citizen; or (3) 50 percent of the vote and value of its shares was not owned, directly or indirectly, by persons other than qualifying persons or residents or citizens of the U.S. and less than 50 percent of Canco's gross income is paid or payable as deductible expenses to persons who are not qualifying persons or residents or citizens of the U.S.³¹⁹

Under the first scenario, if Canco was acquired by USco, Ms. Dunahoo stated that Canco would qualify for treaty benefits under paragraph 2(e) because Canco's shares

³¹⁷ See *supra* note 20 at 44. Since Canada provides a foreign tax credit, or a deduction from income, that allows a Canadian resident to deduct foreign tax paid from their Canadian tax that would otherwise be payable, the denial of treaty benefits will result in a higher total tax payable in only a few cases. However, there could be severe cash flow shortages for Canadian businesses if the imposition of the higher withholding tax was not anticipated. *Ibid.*

³¹⁸ See *supra* note 271 24:11–24:14. In addition to these examples, readers should refer to the LOB flowchart I prepared, at page 150, in order to understand how the LOB Article operates.

³¹⁹ *Ibid.* at 24:11.

would be directly owned by a qualifying person, a corporation resident in the U.S. Under the second scenario, if Canco was acquired by Trco, Canco would be entitled to limited treaty benefits under the derivative benefits provision for its U.S. source dividend, interest and royalty income provided that: (1) Trco, assuming it was a resident of Canada for the purpose of the derivative benefits test, would qualify for benefits as a qualifying person or satisfies the active business test; (2) the rate of U.S. withholding tax under the tax treaty Trco's country of resident has with U.S. is at least as low as the rate under the Convention; and (3) the base erosion test is satisfied. Finally, if Canco was acquired by Ntrco, a company that is not resident in the U.S. nor a country that has a comprehensive tax treaty with the U.S., Canco would not be entitled to treaty benefits under any of the qualifying person tests in paragraph 2 or the derivative benefits test. However, Canco may be entitled to limited treaty benefits under the active business test of paragraph 3 for income that it derives from the U.S. in connection with the active conduct of its trade or business in Canada, as long as the active trade or business in Canada is substantial in relation to the U.S. activity giving rise to the income for which benefits are sought.³²⁰

The second example considers the consequences that would arise when a U.S. company (USco) acquires the shares of a foreign non-qualifying corporation (Fnco) which, in turn, owns a Canadian company (Canco) with business operations in the U.S.³²¹ If Canco was owned directly by USco it would be entitled to treaty benefits for income received from its U.S. operating company (USopco). However, the result is not clear under the facts of this example, where USco owns the shares of Fnco which owns Canco. Canco may be denied treaty benefits as it may not be possible to move Canco out from under its ownership by Fnco. Under the active business test, Canco could be entitled to treaty benefits if it were engaged in the active conduct of a trade or business in Canada, but only for income that is derived in connection with or incidental to the business carried on in Canada and the business carried on in Canada must be substantial in relation to the activity giving rise to the income from the U.S. Alternatively, Canco could be entitled

³²⁰ *Ibid.* at 24:12.

³²¹ *Ibid.* at 24:13.

treaty benefits for its U.S. source dividend, interest and royalty income under the derivative benefits test as it is more than 90 percent owned, indirectly, by a person resident in the U.S. and the base erosion test is satisfied. If Canco fails to qualify under these tests, then, as a last resort, Canco could apply for competent authority relief.

Many commentators have argued that the LOB provisions in U.S. tax treaties are extremely broad and can lead to inappropriate results in many situations.³²² Goossen, while acknowledging that a general LOB provision is reasonable, characterizes the LOB in the Netherlands Treaty as “overkill” and “unworkable in practice”.³²³ The complexity of these provisions presents major obstacles in practice and carries the danger that failing its conditions will result in an extreme penalty of the loss of all treaty benefits.³²⁴

I hope the above two examples demonstrate the intricacy inherent in LOB provisions. Their complexity is also evident by their length as well as their convoluted language. Contemporary LOB provisions are as long as some of the older U.S. tax treaties.³²⁵ If these examples and the Article’s language are not convincing in themselves as to the elaborateness of the LOB Article then the flowchart at the end of this chapter should be persuasive.³²⁶ Also, note the following two descriptions of the LOB Article in the U.S.–Netherlands Tax Treaty, which is very similar to the LOB Article in the Protocol:

At first and even second glance, the limitation on benefits article, of the new treaty is absurdly complex. In a treaty totaling 100 pages of typescript, article 26 consumes 23 pages of turgid, mind-numbing prose, so full of specially defined terms that it needs its own glossary. It is accompanied by 19 pages of further explanation in the

³²² See *supra* note 235 at 34.

³²³ Henk P.J. Goossen, *Limiting Treaty Benefits*, 20 International Tax J. 14, 19 (1994).

³²⁴ Jonathan Kim, *The U.S.–West German Income Tax Treaty: Can Article 28’s Limitation on Benefits Serve as a Model for the Treasury’s Anti-Treaty Shopping Policy?*, 43 Tax Lawyer 983, 1001 (1990). The inclusion of LOB provisions in tax treaties with developing countries has also been criticized and met with strong resistance. Developing countries have argued that LOB provisions are too rigorous because they deny benefits to a potentially large group of foreign investors. The uncertainty created by these provisions discourages some *bona fide* investors from investing in developing countries. See *supra* note 1 at 554.

³²⁵ The LOB provision, Article 26, in the U.S.–Netherlands Tax Treaty, on which the LOB Article in the Protocol is based, is as long as the current U.S.–Ireland Tax Treaty. See *supra* note 13.

³²⁶ See figure 8: The LOB Article flowchart at 150.

Memorandum of Understanding (MOU) accompanying the treaty. Even as a regulation, the complexity of this provision would be open to at least mild criticism. As a treaty article, this overwrought provision may seem almost a joke when compared with typical treaty language, which seldom approaches even the detail of tax statutes.³²⁷

Article 26 of [the Netherlands] treaty contains a Byzantine maze of objective tests that taxpayers must meet in order to qualify as residents for treaty purposes (assuming that they otherwise qualify as such under the treaty's residence article). These tests consist of various ownership and active-business hurdles that apparently were designed to give headaches and ulcers to practitioners who dare attempt to decipher and apply them. Anyone thinking that the practice of international taxation is devoid of humor should read these provisions.³²⁸

The LOB Article is objectionable because it contains many undefined, complex and ambiguous terms. The U.S. Treasury Department has released a technical explanation of the Protocol which will provide some assistance in interpreting the LOB provision.³²⁹ While Canada does not usually release technical explanations of its tax treaties, the Department of Finance stated that the U.S. Treasury Department's Technical Explanation accurately reflects the understandings reached during negotiations.³³⁰ However, a large number of issues were not addressed by the Technical Explanation.³³¹ Further, since the LOB provision will be applied only by the U.S., these terms will be interpreted on the basis of their meaning for purposes of U.S. domestic tax law.³³² This will be a significant obstacle to Canadians and their advisors as they will be unfamiliar with U.S. tax law

³²⁷ Philip D. Morrison & Mary C. Bennett, *The New U.S.-Netherlands Treaty: Part I - The Limitation on Benefits and Related Issues*, Tax Notes Int'l, Feb. 8, 1993, at 331.

³²⁸ Michael G. Brandt and Mark H. French, *Revised Competent Authority Procedure Expand Availability but More Guidance is Needed*, 83 J. Tax 223 (Oct. 1995).

³²⁹ *Ibid.*, and see *supra* note 113.

³³⁰ See Department of Finance News Release June 13, 1995, *supra* note 113.

³³¹ See *supra* note 20 at 45. The LOB articles in other U.S. tax treaties, such as Article 28 in the U.S.-German Tax Treaty and Article 26 of the U.S.-Netherlands Tax Treaty, come with an extensive letter of understanding or MOU that includes definitions and provides examples of the application of the LOB article. While the technical explanation is designed to do this it does not provide the breadth of detail that of these MOUs.

³³² See *supra* note 16 at 970.

which, in general, is more complex than Canadian tax law, both in its actual provisions and in the way it is interpreted and applied administratively and judicially.³³³

While, the LOB Article is intended to limit treaty shopping, many taxpayers not involved in this activity may be adversely affected.³³⁴ The LOB Article fits within the law of unintended consequences as it may cause foreign controlled corporations, highly leveraged private corporations, trusts with non-resident beneficiaries and privately owned companies, especially those held by discretionary family trusts, to lose their previous entitlement to treaty benefits.³³⁵ One of the practical implications of a rigorous LOB provisions, such as that in the Protocol, is the movement away from the use of joint ventures by third-country financial and industrial groups because the restrictions in the LOB Article are restrictive when U.S. or Canadian qualifying residents are not majority owners of the joint ventures.³³⁶

³³³ See *supra* note 20 at 45.

³³⁴ See *supra* note 16 at 964.

³³⁵ Allan R. Lanthier, *Canada-U.S. Protocol*, 2/9 Canadian Tax Highlights 65, 66 (1994) and see *supra* note 16 at 964. The law of unintended consequences, designed by sociologist Robert K. Merton in 1936, states that whenever society takes action to correct something, there will be unanticipated or unintended effects. For example, laws requiring that all new automobiles to be equipped with airbags neglect the unintended consequences that airbags themselves can cause injury or death, particularly to children. So far airbags have been blamed in the deaths of 22 small children. Rob Norton, *Why Airbags are Killing Kids*, *Fortune*, Aug. 19, 1996, at 40. Unintended consequences arise because of ignorance and error on the part of policy makers and the imperious immediacy of interest, that is policy makers want the intended consequences so badly that they purposely ignore any unintended effects. In the case of the LOB Article, it can be argued that the LOB Article's newness and the lack of experience with such articles on the part of U.S. tax treaty policy makers and Canadian treaty negotiators, caused them to fail to recognize its negative consequences. A more convincing argument is that policy makers and negotiators knew the consequences but chose to ignore the evidence. Finally, I would propose that the U.S. policy makers want to stop treaty shopping so badly that they purposefully ignored any of the unintended consequences. Similarly, Canadian negotiators may have wanted the improvements the Protocol provides, particularly for death and estate taxes, so greatly that they also purposefully ignored the unintended consequences of the LOB Article.

³³⁶ In the case of French financial and industrial groups with joint ventures in the Netherlands and investments in the U.S., Boidman concluded that these groups will be forced to restructure their Dutch holdings to avoid the application of the 30 percent U.S. withholding tax. These groups will most likely have to use French corporate structures for direct investments in the U.S. Similarly, the LOB provision in the U.S.-Netherlands Tax Treaty is of intense interest to U.K. tax practitioners because it restricts the use of the Netherlands as a holding location for non-U.K. subsidiaries when a substantial part of a U.K. group's value is in the U.S. Many U.K. tax practitioners regard LOB provisions as a heavy handed approach to treaty shopping because they restrict the use of holding structures which have generally been put in place for commercial reasons and to address the problems caused by the U.K.'s double tax credit rules. See *supra* note 13 and see the U.K. Income and Corporation Taxes 1988, part XVII, section 797-798, which gives credit for foreign taxes on a source-by-source basis, similar to the foreign tax credit regime in Canada. Thus if overseas subsidiaries are held directly in the U.K., dividends from low taxing countries will be subject to an additional U.K. tax but dividends from high taxing jurisdictions give rise to surplus tax credits. Inserting a holding company to hold the overseas investments ameliorates the potential problem of

For some taxpayers the active business test or the derivative benefits test may provide relief. However, as will be discussed below, these exceptions have several inadequacies. Also, it has been speculated that holding company operations might not be able to satisfy the active business test and will be denied treaty benefits.³³⁷ It has been argued that it is clear that the LOB articles in U.S. tax treaties go much farther than simply preventing treaty shopping, according to their wording persons that have absolutely nothing to do with treaty shopping can be deprived of tax treaty benefits if they do not fit within the article's narrow criteria.³³⁸ Canadian residents deserving treaty benefits but who cannot satisfy any of the tests under the LOB Article will be forced to request relief from the U.S. competent authority. This avenue is also not ideal as the criteria for relief are subjective and the burden is on Canadian residents to demonstrate at their expense that they are deserving of treaty benefits. Even Canadian residents who are qualifying persons, or meet one of the other tests, will be impacted by the LOB provision as they will be required to conduct a regular review to ensure that they are in compliance with the LOB Article's requirements. For example, Canadian companies seeking treaty benefits must review changes in their share ownership and the level of payments to non-qualifying persons to ensure that they are in compliance. In referring to the LOB article in the Netherlands treaty, which is very similar to that in the Protocol, Goossen stated that "[t]aken as a whole, these provisions give the impression that the 'prevention of fiscal evasion' in the title of the new treaty has been unthinkingly been set second to the 'avoidance of double taxation.'"³³⁹ LOB articles compromise such a large portion of the U.S. tax treaties that they could be renamed the 'convention for the prevention of fiscal evasion and the avoidance of double taxation,' instead of the 'convention for the avoidance of double taxation and the prevention of fiscal evasion.'

excess credits and additional domestic taxes since the dividends are mixed together and thus come from only source.

³³⁷ See *supra* note 324 at 1001.

³³⁸ *Ibid.*

³³⁹ See *supra* note 323 at 19.

A. Qualifying Persons:

Paragraph 1 of Article XXIX A states that, in determining whether a resident of Canada is entitled to U.S. treaty benefits under the Convention, a *qualifying person* is entitled to all of the benefits of the Convention, and other persons are not entitled to any benefits, except where paragraphs 3, 4, or 6 provide otherwise.

Paragraph 2 lists a number of attributes, any one of which will make a Canadian resident a qualifying person.³⁴⁰ These are mechanical tests. Paragraph 2 states that for the purposes of this Article, a qualifying person is a resident of Canada that is any one of the following:

- 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;³⁴¹
- d) a company more than 50 per cent of the vote and value of the shares³⁴² 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), and 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)

³⁴⁰ The provisions of paragraph 2 are self-executing, unlike the provisions of paragraph 6. The tax authorities may, of course, on review, determine that the taxpayer has improperly interpreted the paragraph and is not entitled to the benefits claimed.

³⁴¹ The term "recognized stock exchange" is defined in paragraph 5(a) of the Article to mean:

1. in the United States, the NASDAQ System and any stock exchange registered as a national securities exchange with the Securities and Exchange Commission, and,
2. in Canada, any Canadian stock exchanges that are "prescribed stock exchanges" under the ITA. These are, at the time of the signature of the Protocol, the Alberta, Montreal, Toronto, Vancouver, and Winnipeg Stock Exchanges.

Additional exchanges may be added to the list of recognized exchanges by exchange of notes between the Contracting States or by agreement between the competent authorities.

³⁴² The shares cannot be term preferred shares (debt substitute shares) as defined by ITA section 248(1)(e).

- i. a company 50 per cent or more of the vote 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 per cent or more of the beneficial interest in which is not owned, directly or indirectly, by persons other than qualifying persons or residents or citizens of the United States,

where the amount of the expenses deductible from 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 per cent of its gross income for that period;

- f) an estate;³⁴³
- 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.

i. *Individuals and Governmental Entities:*

Under paragraph 2, the first two categories of qualifying persons are (1) individual residents of Canada, and (2) the Government of Canada, a political subdivision or local authority thereof, or an agency or instrumentality of that Government, political subdivision, or local authority. The U.S. Treasury Department considers it unlikely that persons falling into these two categories can be used as the beneficial owners of income to derive treaty benefits on behalf of a third country person.³⁴⁴ In the case of a person receiving income as a nominee on behalf of a third country resident, benefits will be denied

³⁴³ Under U.S. tax law an estate does not include a testamentary trust. See *supra* note 16 at 976.

³⁴⁴ See *supra* note 113, Technical Explanation, Article 18. However, there is the significant possibility that a non-resident can establish an address for bank deposits or a bank account in Canada and the funds can be immediately transmitted to the third country resident without Canada exercising its taxing jurisdiction. Although Canada would be losing tax revenues, the result of reduced treaty benefits for a non-qualifying person is inconsistent with the U.S. policy of assuming that revenues are taxed in the country of residence. See *supra* note 199 at 49.

with respect to those items of income because of the requirement that the beneficial owner of the income be a resident of a Contracting State.

ii. *Publicly Traded Corporations and their Subsidiaries:*

Under subparagraph (c), a Canadian resident corporation is a qualifying person if there is "substantial and regular" trading in the company's "principal class of shares" on a recognized exchange.³⁴⁵ Recognized exchanges are exchanges under the NASDAQ system, any exchange registered with the SEC³⁴⁶ or any exchange that is a prescribed exchange under the ITA.³⁴⁷ Canada and the U.S. may agree to add other exchanges in the future as the U.S. has done with the Netherlands under the U.S.–Netherlands Income Tax Treaty. However, Russell speculates that the U.S. will be unwilling to add other exchanges to the list in the Protocol because, unlike the Protocol, the publicly traded test in the U.S.–Netherlands Treaty does not apply to conduit companies unless they meet a base erosion test.³⁴⁸

The underlying theory behind the publicly traded test is that shareholders of a publicly traded company will be located in one of the treaty countries and thus residence taxation will occur.³⁴⁹ The U.S. maintains that in the case of a company that is publicly

³⁴⁵ The term "principal class of shares" is not defined by the Protocol. However, the term is defined in the U.S.–Netherlands Tax Treaty to mean the ordinary or common shares of a company, provided that such shares represent the majority of the voting power and value of the company. *See supra* note 16 at 972. The LOB Article in the U.S.–Netherlands Tax Treaty is very similar to that in the Protocol, thus that Treaty can be used as a reference for terms that are undefined in the Protocol. *See discussion following note 307.*

Further, "substantial and regular trading is also not defined in the Protocol. The U.S.–Netherlands Treaty may offer some guidance. It defines shares to be substantially and regularly traded on a recognized exchange if trades are effected on one or more recognized exchanges other than in de minimis quantities during every month and the aggregate number of shares traded on such exchanges during the previous year is at least 6 percent of the average number of shares outstanding for that particular class. *See supra* note 16 at 972–73.

³⁴⁶ This would include the New York Stock Exchange, The American Stock Exchange and the other major U.S. exchanges. *Ibid.* at 971.

³⁴⁷ *See supra* note 341.

³⁴⁸ *See supra* note 16 at 972. Any reluctance on the part of the U.S. to add further exchanges to the list of recognized exchanges would be unfortunate as this test, unlike the one in the Mexico Treaty, does not make any provision for exchanges located in NAFTA member countries. The list of recognized exchanges in the Mexico Treaty is not limited to exchanges in the U.S. and Mexico but it includes exchanges in NAFTA member countries. In order to further the policies of NAFTA and encourage consistency in U.S. treaties with NAFTA member countries, the publicly traded test in the Protocol should include a provision similar to that in the Mexico Treaty.

³⁴⁹ *See supra* note 201 at 35.

traded there is no need to analyze the ultimate beneficial owners because public scrutiny will prevent the company from engaging in dubious treaty shopping.³⁵⁰ However, these reasons have been criticized as not being convincing.³⁵¹ First, the act of listing a company in a treaty country does not guarantee local ownership. A company can be listed on a number of exchanges, and thus its listing on a Canadian exchange does not ensure Canadian ownership over foreign ownership. Second, while the corporation may be subjected to greater scrutiny, this is not equivalent to a base erosion restriction that examines whether deductible payments are made to third country residents. Third, generally the board of directors and management have direct control of the corporation they may have an incentive to earn income through treaty abuse in order to report greater earnings to their shareholders. The publicly traded test has also been criticized because, while acknowledging that it provides an administrative rule of convenience, the administrative difficulty in determining the residence of beneficial owners of shares should not exempt a public corporation from meeting the base erosion test any more than a corporation which is not listed but which meets that test.³⁵² Finally, the publicly traded test has been criticized because a publicly traded investment company could qualify even if wholly owned by third-country residents. This is contrary to the policy behind the LOB Article.³⁵³

Certain other companies that fail the public ownership test but are owned by publicly traded companies can also be qualifying persons. Under subparagraph (d), a Canadian resident company will be a qualifying person, even if it is not publicly traded, if more than 50 percent of the vote and value of its shares, other than “debt substitute shares,”³⁵⁴ are owned, directly or indirectly, by five or fewer persons that are qualifying

³⁵⁰ See *supra* note 323 at 27.

³⁵¹ See *supra* note 291 at 252–53.

³⁵² *Ibid.* at 253.

³⁵³ *Ibid.*

³⁵⁴ The term “debt substitute shares” is defined in paragraph 5 of the LOB Article to mean shares defined in ITA section 248(1)(e), the definition of “term preferred shares,” which relates to certain shares received in debt restructuring arrangements undertaken by reason of financial difficulty or insolvency. However, paragraph 5 also provides that the competent authorities may agree to treat other types of shares as debt substitute shares.

persons under subparagraph (c). In addition, each company in the chain of ownership must be a qualifying person or a U.S. citizen or resident. The U.S. Treasury Department provides an example of a Canadian company that will qualify under subparagraph (d).³⁵⁵ In the example, a company that is not publicly traded but is owned, one-third each, by three companies, two of which are Canadian resident corporations whose principal classes of shares are substantially and regularly traded on a recognized stock exchange, is a qualifying persons as more than 50 percent of the vote and value of its shares are owned, directly or indirectly, by five or fewer persons that are qualifying persons under subparagraph (c).

a) Problems with the Publicly Traded Corporation Test:

The central problem with this test is that it does not define the terms “substantial and regularly trading” or “principal class of shares.” While “substantial and regular trading” is not defined by the Protocol or the Technical Explanation, the U.S. branch profits tax rules and regulations can be used for guidance as to what constitutes “substantial and regular trading.” Though the branch profits tax provisions do not use the exact term “substantial and regular trading” they do use the analogous phrase “primarily and regularly traded.”³⁵⁶ Under these rules, primarily refers to the number of shares traded in each class of stock in the corporation’s country of residence. This amount should exceed the number traded in any other foreign country in that taxable year.³⁵⁷ The corporation’s stock is “regularly” traded if: (1) one or more classes of its stock, equal to more than eighty percent of the total vote, of all stock entitled to vote, and more than 80 percent of the total value of stock is listed on the securities exchange in the corporation’s country of residence; (2) the stock is traded for sixty days, excluding *de minimis* amounts; and (3) at least ten percent of the average number of shares outstanding in each class are traded during the taxable year.³⁵⁸ Stock that is closely held or traded between related

³⁵⁵ See *supra* note 113, Technical Explanation, Article 18.

³⁵⁶ IRC section 884(e)(4)(B)(i).

³⁵⁷ Treas. Reg. 1.884-5(d)(3).

³⁵⁸ Treas. Reg. 1.884-5(d)(4)(i).

persons is excluded from the “regularly” traded test.³⁵⁹ An anti-abuse rule can apply to exclude trades conducted to meet these requirements.³⁶⁰

Likewise the term “principal class of shares” is not defined by the Protocol, but it is defined by the U.S.–Netherlands Treaty and this may provide guidelines for determining if a Canadian corporation’s class of shares is its principal class of shares.³⁶¹ That Treaty defines “principal class of shares” to mean the ordinary or common shares of a company, provided that such class of shares represents the majority of the voting power and value of the company. Where there is no single class of shares that represents the majority of the voting power and value of the company, the principal class of shares is generally the aggregate of those classes that together compromise more than 50 percent of the voting power and value of the company.

The other primary problem with this test is that a typical share structure that is used in Canada to retain control of a public corporation within a family group may no longer qualify for treaty benefits under the Protocol. Some Canadian resident companies issue class A voting shares and class B non-voting shares, where the class A shares are privately held and only the class B shares are publicly traded.³⁶² Applying the definition of “principal class of shares” from the U.S.–Netherlands Treaty, a Canadian resident company that uses a share structure where voting control resides in the privately held shares and the publicly traded shares are non-voting, or do not compromise 50 percent of the voting power or value of the company, will not meet the publicly traded test under the definition of a qualifying person.³⁶³ Such a company will have to qualify for treaty benefits under an alternate test or restructure.

³⁵⁹ Treas. Reg. 1.884–5(d)(4)(iii).

³⁶⁰ Treas. Reg. 1.884–5(d)(4)(iv).

³⁶¹ See *supra* note 16 at 972.

³⁶² *Ibid.*

³⁶³ *Ibid.*

b) Problems with Subsidiary of a Publicly Traded Corporation Test:

As discussed above, a company that itself fails the publicly traded test can still be a qualifying person if more than 50 percent of the vote and value of its shares are owned, directly or indirectly, by five or fewer people, each of whom is a corporation or trust that has met the publicly traded test. Each corporation or trust in the chain of ownership must be a qualifying person or a resident or citizen of the U.S. The intent of this test is to allow a subsidiary, that is not publicly traded and thus not a qualifying person, to become a qualifying person if it is owned by a publicly traded company. Thus companies that are beneficially owned by qualifying persons fulfill the definition of qualifying person and are entitled to treaty benefits as the beneficial owners are.

While the intent of this test is to allow subsidiaries that do not fulfill the requirement of a qualifying person to obtain treaty benefits because they are owned by qualifying persons, this may not always be the result. Russell provides an example where a subsidiary resident in Canada will not be entitled to treaty benefits even though the beneficial owner is a qualifying person.³⁶⁴ Consider a company resident in Canada, Canco, that purchases all the shares of a company resident in Hong Kong, HKco, which has a wholly owned subsidiary resident in Canada, Subco. Canco is a qualifying person, because its shares are substantially and regularly traded on a recognized exchange and thus all the companies that it owns more than 50 percent of the vote and value should also be qualifying persons. However, Subco does not meet the qualifying person test because, although it is indirectly owned by a qualifying person (Canco), HKco, one of the companies in the chain of ownership, is not a qualifying person or a resident of the U.S. Thus, the intent of the test, to grant treaty benefits to the subsidiaries of qualifying persons, is defeated because a non-qualifying person is part of the chain of ownership. In order for Subco to obtain treaty benefits Canco would have to liquidate HKco. Alternatively, Subco would have to try to qualify under another test, such as the active business test, or request the U.S. competent authority to grant it treaty benefits. The

³⁶⁴ *Ibid.* at 974.

ultimate result could be that Subco could be denied treaty benefits even though Subco is beneficially owned by a qualifying person and is not engaged in treaty shopping.

As can be imagined, this result could easily occur inadvertently in a number of different ways. If a qualifying person interposed a non-resident corporation, such as a foreign affiliate, to comply with some foreign law or to limit liability it could lose its subsidiary's entitlement to treaty benefits if the foreign affiliate owns more than 50 percent of the subsidiary's shares. Qualifying persons, and their tax practitioners, would be well advised to examine their corporation structure to ensure that only qualifying persons are in the chain of ownership of subsidiaries that they desire to be entitled to treaty benefits.

Another aspect of this test that may prove troubling, and which does not have any justification, is the requirement that the subsidiary be owned by five or fewer publicly traded companies. It is unclear why there should be a limit of five publicly traded companies that can own more than 50 percent of the vote and value of the subsidiary. The Technical Explanation to the Protocol does not provide an explanation for this. O'Brien states that the arbitrariness of a limit on ownership of five or fewer public companies is inexplicable.³⁶⁵ The concern for treaty shopping is addressed by the requirement that, where a Canadian corporation is indirectly owned, each corporation or trust in the chain must be a qualifying person or resident or citizen of the U.S., not by an arbitrary limit on ownership. Russell has identified an anomalous dilemma as a result of this limit.³⁶⁶ Suppose six Canadian resident companies incorporate another Canadian resident company, Subco, to carry out a joint venture. If five of the companies meet the publicly traded test and own 40 percent of the vote and value of Subco and the sixth company is privately held and owns the remaining shares then Subco would not be a qualifying person under the subsidiary of a publicly traded company test. Subco would have to rely on another test to be entitled to treaty benefits. Alternatively, the joint venturers would have to reorganize their shareholdings in order that the publicly traded companies own more

³⁶⁵ See *supra* note 20 at 46.

³⁶⁶ See *supra* note 16 at 974.

than 50 percent of the shares of Subco. Further, consider a joint venture that is a corporation incorporated in Canada, 50 percent owned by a Canadian qualifying person and 50 percent owned by a foreign company.³⁶⁷ The joint venture company would not be a qualifying person because it is not *more than* 50 percent owned by qualifying persons, even though it is a Canadian controlled private company under the ITA.³⁶⁸

Finally, another potential problem that Russell has identified is the treatment of American Depositary Receipts ("ADRs"), specifically whether they qualify as shares under the publicly traded and subsidiary of a publicly traded corporation tests.³⁶⁹ An ADR is the traditional alternative foreign corporations utilize to issue certificates of their securities in the U.S. without actually undergoing the complex and expensive process of registering and issuing their securities. Through this method foreign securities are placed in a central depository and ADR certificates, representing a share of the depository's holdings, are traded in the American securities markets. Thus, an ADR is a certificate that represents an interest in the shares of a foreign corporation. The ADR, not the share, is issued to shareholders. Russell speculates that if ADRs are viewed as shares then many foreign controlled Canadian companies, specifically Canadian resident companies owned by foreign corporations whose ADRs are traded on a recognized exchange, will meet the subsidiary of a publicly traded corporation test.³⁷⁰ However, she states that while the U.S. has not addressed this matter, informal discussions with the IRS suggest that the IRS will not view ADRs as shares for the purpose of the Protocol.³⁷¹ This is the case even though under the U.S.-Netherlands Treaty shares include receipts and trust certificates in respect of shares.

³⁶⁷ This example is taken from O'Brien, *see supra* note 20 at 46.

³⁶⁸ ITA subsections 125(7) and 248(1).

³⁶⁹ *See supra* note 16 at 974.

³⁷⁰ *Ibid.*

³⁷¹ *Ibid.*

iii. *Ownership and Base Erosion Tests:*

While the definition of a qualifying person is broad, it excludes corporations that do not have a close connection to Canada or the U.S. and which pay a majority of their expenses to a non-Canadian or non-U.S. residents. Subparagraph (e) of paragraph 2 provides a two part test under which entities, other than governmental or publicly traded entities, may be qualifying persons based on *ownership* and *base erosion* tests.³⁷²

Under the ownership test, benefits will be granted to a Canadian resident company if 50 percent or more of the vote and value of its shares (other than debt substitute shares), or to a Canadian resident trust if 50 percent or more of its beneficial interest, is *not* owned, directly or indirectly, by persons other than qualifying persons or U.S. residents or citizens.³⁷³ The objective is to identify the ultimate ownership as being in the hands of entities located in either Canada or the U.S.

Unlike the definitions of qualifying person in other recent U.S. tax treaties, the wording of this definition is written in double negatives. This is intended to make clear that if a Canadian company is more than 50 percent owned by a U.S. resident corporation that is, itself, wholly owned by a third country resident other than a U.S. citizen or resident, the Canadian company would not pass the ownership test because more than 50 percent of its shares are owned indirectly by a person (the third country resident) that is not a qualifying person or a citizen or resident of the United States.³⁷⁴ The definition of a qualifying person was written in double negatives because U.S. negotiators were concerned that ineligible persons would be able to avail themselves of treaty benefits by using a Canadian holding company or trust and avoid Canadian taxation by paying out most of their income as expenses to third party countries.³⁷⁵ As a result of this negative wording, the status of any company or trust in the chain of ownership as a qualifying

³⁷² See *supra* note 113.

³⁷³ The required holding of 50 percent owned by an eligible person was negotiated to be lower than a similar provision in the U.S. Model Tax Treaty that mandated a holding requirement of 75 percent owned by an eligible person. See *supra* Gelardi note 112.

³⁷⁴ See *supra* note 113.

³⁷⁵ See Gelardi *supra* note 112 at 58.

person will depend upon whether any owner higher in the chain is not a qualifying person or not a resident or citizen of the U.S.³⁷⁶ For instance, Geraldini provides an example where Saudi residents own a U.S. resident company that owns a Canadian holding company which in turn owns a Canadian operating company and the operating company pays 75 percent of its gross income to a company in Kuwait. The operating company would not be a qualified person under the Treaty as it is *indirectly* owned by Saudi residents.³⁷⁷ However, if the LOB Article decreed that only companies directly owned by qualified persons would be entitled to treaty benefits, then the Canadian operating company would qualify as it is *directly* owned by a qualified person.

The second test of subparagraph (e) is the *base erosion* test.³⁷⁸ A Canadian corporation or trust that passes the ownership test must *also* pass this test to be a qualifying person. This test requires that the amount of expenses that are paid by the Canadian entity in question to persons that are not qualifying persons or U.S. citizens or residents, and that are deductible from gross income, be less than 50 percent of the gross income of the company or trust. This test is applied for the fiscal period immediately preceding the period for which the qualifying person test is being applied. Thus, if the person fails the base erosion test they will not be able to qualify *until their third fiscal period*. For example, if an entity applies for treaty benefits in 1996 but they did not meet the base erosion test in their preceding year, 1995, they will not be able to qualify for treaty benefits until 1997, assuming they met the test in 1996. However, if it is the entity's first fiscal period, the test is applied for the current period.

The ownership and base erosion tests recognize that the benefits of the treaty can be enjoyed indirectly not only by equity holders of an entity, but also by that entity's obligees, such as lenders, licensors, service providers, insurers and reinsurers, and others.³⁷⁹ The United States Treasury Department provides an illustrative example of this

³⁷⁶ See *supra* note 16 at 975.

³⁷⁷ See Gelardi *supra* note 112 at 59 (emphasis added).

³⁷⁸ See *supra* note 113.

³⁷⁹ *Ibid.*

situation. They state that a third country resident could license technology to a Canadian owned and resident corporation to be sub-licensed to a U.S. resident. The U.S. source royalty income of the Canadian corporation would be exempt from U.S. withholding tax under Article XII (Royalties) of the Treaty. While the Canadian corporation would be subject to Canadian corporate income tax, its taxable income could be reduced to near zero as a result of deductible royalties paid to the third country resident. If, under a tax treaty between Canada and the third country, those royalties were either exempt from Canadian tax or subject to tax at a low rate, the U.S. treaty benefit with respect to the U.S. source royalty income would have flowed to the third country resident at little or no tax cost, with no reciprocal benefit to the United States from the third country.³⁸⁰ The ownership and base erosion tests therefore require both that qualifying persons or U.S. residents or citizens substantially own the entity and that the entity's deductible payments be made in substantial part to such persons.³⁸¹

a) Problems with the Ownership and Base Erosion Tests:

As discussed above, under the ownership and base erosion tests a private company or trust will be a qualifying person if more than 50 percent of the vote and value of their shares/beneficial interests *are not owned*, directly or indirectly, by persons other than qualifying persons or residents or citizens of the U.S. *and* less than 50 percent of their deductible expenses are paid or payable to person who are not qualifying persons or residents or citizens of the U.S. The requirement to satisfy both the ownership and base erosion tests in order for a private corporation or trust to be a qualifying person may result in some unexpected problems.

First, a trust that was a qualifying person prior to the Protocol, as well corporations whose shares are held by a trust, will lose their entitlement to treaty benefits if 50 percent of the beneficial interests in the trust are owned by beneficiaries who are not residents of Canada. Additionally, and more troubling, if a beneficiary, owning more than

³⁸⁰ *Ibid.*

³⁸¹ *Ibid.*

50 percent of the beneficial interest of a trust, who was previously a resident of Canada or the U.S., becomes a resident of a third country the trust will lose its entitlement to treaty benefits.³⁸² Thus, tax practitioners must keep in mind that whenever a beneficiary of a trust decides to change her residence the issue of whether any valuable treaty benefits will be foregone will have to be considered. Further, actions can be taken to prevent the loss of treaty of benefits, such as varying the terms of the trust or transferring interests in the trust to maintain the trust's status as a qualifying person.³⁸³

Second, there are several potential problems with the base erosion test. The base erosion test is basically a comparison of deductible expenses to gross income. If deductible expenses paid to persons who are not qualifying persons nor residents or citizens of the U.S. exceed 50 percent of gross income then the base erosion test will not be met. The concept behind this test is that although shares of a corporation are controlled by qualifying persons or U.S. residents or citizens, if the earnings of the corporation flow as deductible expenses to non-qualifying persons or persons who are not residents or citizens of the U.S. then there is a danger of treaty shopping.³⁸⁴ One of the potential problems, that was highlighted above with this test is that it is based on the amount of deductible expenses paid in the preceding year. A company that fails to satisfy this test in one year but satisfies it in the second year is required to wait until the third year before it can be considered a qualifying person.³⁸⁵ Additional problems can arise because neither the Protocol nor its Technical Explanation define "gross income" or "deductible expenses." Under this test, the expenses relevant are those deductible from gross income. It, therefore, becomes important to identify what types of expenses fall within the definition of deductible expenses. As discussed above in the section on interpreting the Protocol, these terms will be conferred meaning from U.S. domestic tax law, or appropriate guidance as to their meaning can be found in the other U.S. tax treaties.

³⁸² See *supra* note 16 at 975.

³⁸³ *Ibid.*

³⁸⁴ See *supra* note 20 at 46.

³⁸⁵ See discussion following note 378 and *supra* note 16 at 975.

“Gross income” for U.S. tax purposes in the 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.³⁸⁶ The branch profit regulations define “deductible payments” as including interest, rent, royalties, and reinsurance premiums.³⁸⁷ O’Brien reports that the Tax Policy Branch of the U.S. Treasury Department has not developed any detailed interpretation of these terms in the context of this or any other U.S. tax treaty.³⁸⁸ However, officials from the U.S. Treasury Department gave their opinion at the 1994 Canadian Tax Foundation Conference that payments for the purchase of raw materials for use by Canadian corporations, and possibly rental payments for factory premises, would be included in the cost of sales, they would not be expenses deductible from gross income.³⁸⁹

Further, the Protocol to the U.S.–Mexico Tax Treaty defines “gross income” as gross receipts or gross receipts less the direct costs of labor and materials in the case of a manufacturing or producing activity. Gelb states that this definition indicates that earnings paid to foreign employees of a manufacturing or production company, would not, as the direct costs of labor, be subject to the base erosion limitations.³⁹⁰ Thus, an opportunity exists for third-country residents obtaining treaty benefits. Applying this definition a Canadian company that is more than fifty percent owned by Canadians can be stripped of all its earnings by residents of other countries. For example, a Canadian company that is fifty-one percent owned by Canadian residents and forty-nine percent owned by third

³⁸⁶ See *supra* note 20 at 46.

³⁸⁷ Treas. Reg. section 1.884–5(c).

³⁸⁸ See *supra* note 20 at 46.

³⁸⁹ Statement by Carol A. Dunahoo, Associate International Tax Counsel, U.S. Treasury Department, made at the 1994 Canadian Tax Foundation Conference, *cited by* O’Brien note 20 at 46. Ms Dunahoo stated that payments such as those for the purchase of raw materials for use by a Canadian corporation (“Canco”) to manufacture its product would be included in cost of sales, and therefore would not be expenses deductible from gross income. Rental payments for factory premises might also be excluded. However, if the payments to a non-treaty Hong Kong corporation (HKco) were payments of interest or royalties, they might, depending on the circumstances, be considered to be deductible from Canco’s gross income. The commentators who reported this portion of the 1994 tax conference stated that they hoped that further clarification of the meaning of gross income would be forthcoming in the technical explanation to the Protocol. However, this has not occurred. See *supra* note 271 at 24:13–24:14.

³⁹⁰ See *supra* note 291 at 238.

country residents, who are also the company's employees and thus derive most of the earnings of the company as wages, can stripped of its earnings in this fashion.³⁹¹

The base erosion test specifies that payments to any person that is not a qualifying person or not a resident or citizen of the U.S. will be taken into account in calculating the threshold of allowable deductible expenses. Consequently, depending on how "deductible expenses" and "gross income" are defined, payments to arm's-length third parties may prevent a company from satisfying the base erosion test.³⁹² For example, a Canadian computer software manufacturer that exports to the U.S. may not be entitled to treaty benefits if a majority of its expenses happen to be computer hardware purchases from Taiwan or software royalty fees. Another example where treaty benefits may be denied is where a Canadian private company that owes a significant amount of debt to the Canadian subsidiary of a foreign bank, which is not a qualifying person or not a resident or citizen of the U.S.³⁹³ The Canadian private company will fail the base erosion test because it failed to select a Canadian bank as its lender. Even if the company attempted to avoid this situation, it could unexpectedly arise if its originally Canadian lender was purchased by a foreign bank after the loan was made. Thus, a company that transacts a significant amount of business in the U.S. will be adversely affected unless it can qualify for treaty benefits under another provision of the LOB.

In the U.S., a situation of international base erosion would be unusual. However, in countries with much smaller economies, such as Canada and smaller European countries, base erosion is more likely to occur since the corporations in these countries pay a large portion of their deductible expense to non-residents. Countries with smaller economies usually depend heavily on foreign businesses without intending to treaty shop.³⁹⁴ Consequently, the base erosion provision may unexpectedly affect corporations with an active business not engaged in treaty shopping. Canadian corporations that want

³⁹¹ *Ibid.*

³⁹² *See supra* note 16 at 975.

³⁹³ *Ibid.*

³⁹⁴ *See supra* note 323 at 42.

to ensure they are entitled to treaty benefits may find themselves limited in their purchasing, reselling and financing activities to qualified persons in Canada and the U.S. However, this may be impossible as it will be difficult for a Canadian taxpayer to know with any certainty whether the Canadian resident they are dealing with is in fact a qualified person or the subsidiary of a third-country corporation. This extraordinary result is even more unpalatable when one realizes that there are no provisions in the LOB Article, or the Protocol, that recognize the economic relationship that NAFTA has created between Canada, the U.S. and Mexico. While the LOB provision in the U.S.-Mexico Tax Treaty makes provision in its base erosion test for payments to Canadian entities, incredibly the LOB Article in the Protocol does not. What is even more unbelievable is that the Mexico Treaty was ratified three years before the Protocol. Thus Canadian negotiators were well aware of its provisions but apparently made no effort to ensure that a similarly relaxed base erosion test was included in the Protocol.

O'Brien provides a comprehensive and illustrative example of the problems the base erosion test can create.³⁹⁵ In figure 5 Canco is a Canadian resident private company whose shares are held 51 percent by a qualifying person and 49 percent by a U.K. holding company ("UK holdco"). Canco distributes database management software in North America under an exclusive distribution agreement and trademark license from the UK holdco. In return Canco will pay UK Holdco 5 percent of its gross profit on each system sold as commission, a \$100,000 trademark royalty fee and it will repay a loan of \$1 million at 10 percent that it borrowed from UK Holdco to cover the startup costs of its distribution network. Canco distributes the software in Canada and in the U.S. through a branch office in Seattle. It generates over half of its income from its U.S. branch operation. In 1995, Canco had gross income of \$1 million, it paid UK holdco \$50,000 in commissions, \$100,000 in royalties and \$100,000 in interest. Canco's total deductible expenses paid to UK Holdco was 25 percent of its gross income, thus Canco would be a qualifying person under the base erosion test. However, in 1996, the year the LOB provision in the Protocol came into effect, Canco's gross income dropped to \$400,000 as

³⁹⁵ The following example and diagram are adopted from O'Brien *See supra* note 20 at 46-48.

the software is found to be incompatible with Windows 95 and a competitor with a superior and compatible product enters the market. Canco pays total commissions, royalties and interest of \$220,000 to UK holdco. This exceeds 50 percent of its gross income and Canco is no longer a qualifying person under the base erosion test. Canco will have to rely on the active business test in order to be entitled to treaty benefits for the branch profits that it receives from its U.S. branch office.

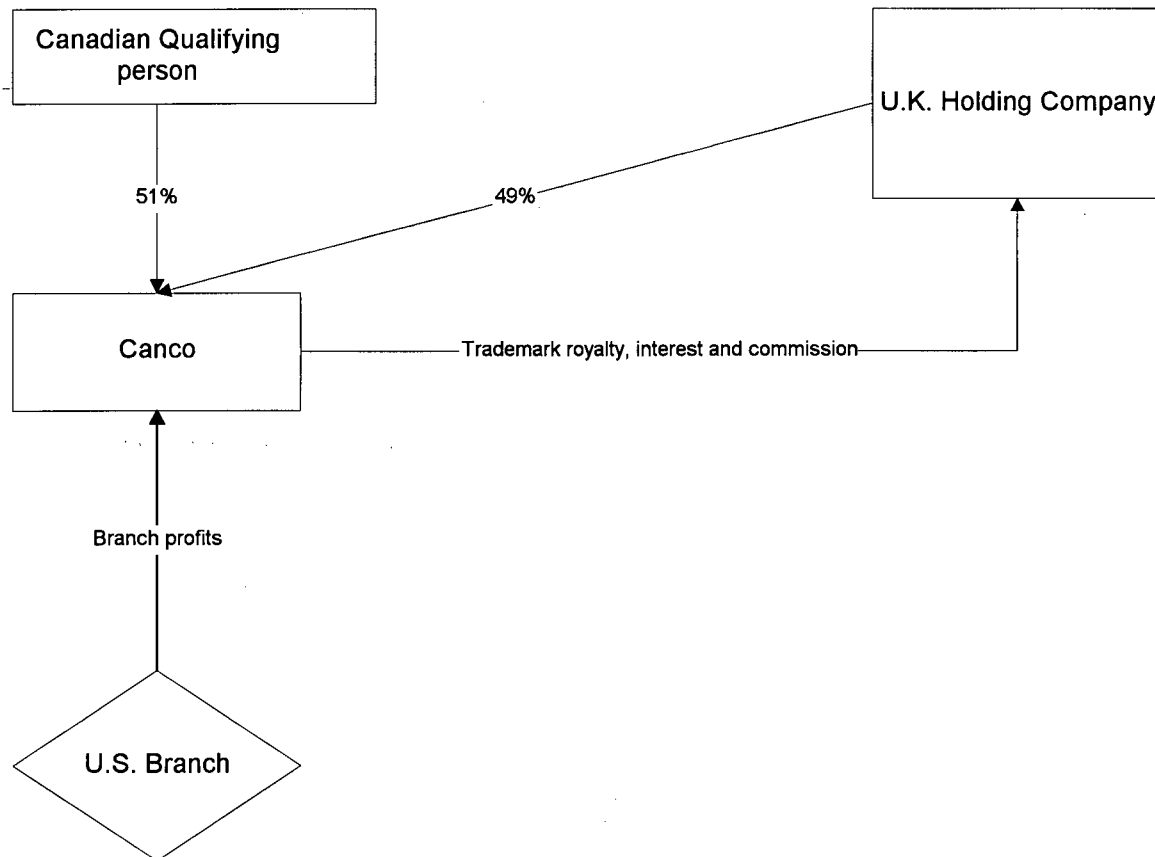


Figure 5: Base Erosion Test: Example of Deductible Expenses Limitation

Another situation that could unexpectedly result in failing the base erosion test would be a change in the value of the Canadian Dollar in relation to foreign currency rates. In the above example, if the interest payments to UK holdco were denominated in a foreign currency and the Canadian Dollar dropped in value against that currency, the interest cost as a percentage of gross income would increase. Assume that in 1995,

Canco's gross income was \$500,000 and it paid UK holdco \$100,000 in royalties, \$25,000 in commissions and interest of 40,000 U.K. Pounds, on a loan for 400,000 Pounds. The loan of 400,000 Pounds and interest payments at 10 percent were denominated in U.K. Pounds. Assuming an exchange rate 3.0 Dollars per Pound, the total expenses paid to U.K. Holdco was \$245,000. The following year the Canadian Dollar falls in value to the U.K. Pound, the exchange rate is now \$3.15 per Pound. Canco would no longer qualify under the base erosion test even if its gross income was identical to the previous year as the total expenses paid to UK holdco increase to \$251,000, which is 50.2 percent of its gross income. O'Brien concludes that fluctuations in foreign currency will be a large concern for Canadian companies that are highly leveraged or have narrow gross profit margins.³⁹⁶

In addition, the base erosion test will prove problematic because, while a company may be able to monitor the ownership of the vote and value of its shares to satisfy the ownership test, monitoring whether it is making payments to a qualifying person or a resident or citizen of the U.S. will prove difficult if not impossible. A company that desires to maintain its status as a qualifying person under this test will have to know the status of those it is making payments to. Russell speculates that companies that do not know the status of those it is making payments to may seek assurances from them that they are qualifying persons or residents or citizens of the U.S.³⁹⁷ Additionally, she states that the base erosion test creates the situation whereby the status of being a qualifying person or resident or citizen of the U.S. may become an important factor in selecting a person as a supplier or creditor.³⁹⁸

Further, as mentioned above, the base erosion test restricts the lenders that Canadian residents can borrow funds from to financial institutions which are qualifying persons or residents or citizens of the U.S. In determining from whom to seek financing, Canadian residents should note that resident Canadian subsidiaries of foreign financial

³⁹⁶ See *supra* note 20 at 47.

³⁹⁷ See *supra* note 16 at 976.

³⁹⁸ *Ibid.*

institutions that are neither qualifying persons nor residents or citizens of the U.S. are not qualifying persons under the Protocol regardless of their Canadian residence. Therefore, if a Canadian resident borrows from a foreign financial institute or its non-qualifying subsidiary the interest expenses would be counted in the calculation of deductible expenses paid to third country residents out of gross income.³⁹⁹ Similarly, and even more troubling, is that office rent paid to a Canadian subsidiary of a foreign corporation will also be included on the expense side of the base erosion test.⁴⁰⁰ Thus, the base erosion test imposes limitations, either intentionally or inadvertently, on the ability of Canadian private companies, who desire treaty benefits, to obtain access to foreign capital and goods. Only time will tell whether an obligee's status as a qualifying person, citizen or resident of the U.S. will demand a premium in the future from Canadian entities seeking treaty benefits.

The effect of a Canadian resident failing the ownership and base erosion tests is that they will not be a qualifying person and thus not entitled to treaty benefits, unless they can satisfy one of the limited exceptions. Additionally, any Canadian resident subsidiaries of the non-qualifying Canadian resident will also cease to be qualifying persons.⁴⁰¹ Furthermore, Canadian resident companies that pay a significant portion of their deductible expenses to non-qualifying resident companies, such as Canco in the previous example, or their subsidiaries will also lose their status as qualifying persons if they pay large portions of their deductible expenses to third country residents.⁴⁰² Hence, the ultimate effect of the ownership and base erosion tests is that Canadian resident private companies with U.S. source income that want to ensure that they will be qualifying persons under the LOB Article should set up strict compliance programs to monitor who owns their shares and, an even more complex program, to monitor to whom they are paying deductible expenses and whether that person's status has or will change in the

³⁹⁹ See *supra* note 20 at 47.

⁴⁰⁰ *Ibid.*

⁴⁰¹ *Ibid.*

⁴⁰² *Ibid.*

future.⁴⁰³ However, as discussed above, it may be difficult to know, particularly in the case of arm's-length relationships between private companies, whether one is dealing with qualifying persons, a Canadian resident corporation that is a subsidiary, especially one in a complex multinational corporate chain which includes other Canadian corporations, or if the qualifying person's status has changed as a result of: a merger, a sale of shares, or because its level of expense payments to third country residents violates the base erosion test.⁴⁰⁴

iv. *Other Qualifying Persons:*

In addition to the qualifying persons enumerated above, subparagraphs (f), (g) and (h), of paragraph 2, specify that estates, not-for-profit organizations and exempt organizations, respectively, will be qualifying persons. Subparagraph (f) establishes that a Canadian resident estate is a qualifying person and is entitled to treaty benefits on its U.S. source income without limitation. There is no restriction, either in the Protocol or its Technical Explanation, on the ability of a Canadian resident estate to be a qualifying person. Canadian estates, as Canadian individuals, are unequivocally entitled to treaty benefits.⁴⁰⁵

Under subparagraph (g) a not-for-profit organization that is a resident of Canada is a qualifying person, and thus entitled to U.S. benefits, if more than half of the beneficiaries, members, or participants are qualifying persons or citizens or residents of the United States. A "not-for-profit organization" is defined in paragraph 5(b) of the LOB Article as an entity created or established in that State that is generally exempt from income taxation in that State by reason of its not-for-profit status. This includes charities, private foundations, trade unions, trade associations, and similar organizations.⁴⁰⁶

⁴⁰³ Canadian entities have a strong incentive for setting up such compliance programs because, as mentioned above, failing the base erosion test carries a stiff penalty as treaty benefits will be denied not only for that particular year but also for the following year. Treaty benefits will not be granted again until the year after the Canadian resident becomes a qualifying person.

⁴⁰⁴ See *supra* note 20 at 48.

⁴⁰⁵ See *supra* note 113, Technical Explanation Article 18.

⁴⁰⁶ *Ibid.*

Subparagraph (h) of paragraph 2 states that organizations described in paragraph 2 of Article XXI (Exempt Organizations) are qualifying persons. To be a qualifying person, these organizations must be established “primarily” for the purpose of providing pension, retirement, or employee benefits to individual residents of Canada who are, or were, within any of the five preceding years, qualifying persons, or to citizens or residents of the United States. An organization will be considered to be established “primarily” for this purpose if more than 50 percent of its beneficiaries, members, or participants are such persons. Therefore, for example, a Canadian pension fund established to provide benefits to persons employed by a company would be a qualifying person only if most of the beneficiaries of the fund are, or were within the five preceding years, individual residents of Canada or residents or citizens of the United States. Thus, a Canadian Registered Retirement Savings Plan (“RRSP”) of a former resident of Canada who is working temporarily outside of Canada would continue to be a qualifying person during the period of the individual’s absence from Canada for up to five years.⁴⁰⁷

v. *Tax Planning Considerations under the Qualifying Persons Tests:*

From the perspective of international tax practitioners, the initial challenge of the LOB Article will be to identify the criteria that will or will not fulfill the conditions of the Article and thus avoid the denial of treaty benefits for their clients.⁴⁰⁸ Determining whether a client is entitled to treaty benefits under the tests of Paragraph 2 of the LOB Article, specifically sub-paragraphs (a), (b), (c), (d), (f), (g) and (h), has been rendered somewhat easier by virtue of the objective nature of these tests. Further, the Protocol and its Technical Explanation contain some definitions and explanations that provide limited assistance with the application of these tests.⁴⁰⁹

With respect to subparagraphs (a) and (b), under which individuals and government entities are qualified persons, tax practitioners will want to confirm that clients are not subject to an agency type of relationship where a third country resident

⁴⁰⁷ *Ibid.*

⁴⁰⁸ See *supra* note 324 at 1002.

⁴⁰⁹ *Ibid.*

ultimately emerges as the beneficial owner.⁴¹⁰ Further, concerns may arise with respect to the terms “political subdivision” and “local authority” in sub-paragraph (b), as they are not defined in the Protocol or its Technical Explanation. Tax practitioners in doubt as to the status of the entity in question should turn to the definition assigned to the term under the U.S. domestic tax law.

Any concerns as to the status of a “not-for-profit organization” under subparagraph (g) or a “recognized exchange” under subparagraph (c) are answered by the definitions in Paragraph 5 of the Article. Similarly, any concerns about “exempt organizations” in subparagraph (h) should be answered by referring to the definition in Article XXI. However, as discussed above the terms “substantial and regular trading” and “principal class of shares”, in reference to subparagraph (c) and (d), will be troublesome for tax practitioners as they are not defined in the Protocol or its Technical Explanation. As already discussed, practitioners will have to refer to U.S. domestic tax law, or the usage of these terms in other U.S. tax treaties, when determining whether their clients fit within these tests.

Subparagraph (e) defines the criteria for a company or trust, which does not satisfy one of the other definitions of a qualifying person, in terms of a percentage of ownership by qualifying persons and the satisfaction of a base erosion test. While this test is defined in terms of clear cut percentages, certain aspects will create problems for tax practitioners seeking relief for their clients. The double negative aspect of the ownership test, which defines ownership in terms of “not owned directly or indirectly” may prove troublesome for tax practitioners as they will have to inquire into their client’s entire chain of ownership to determine whether this test is satisfied. Additionally, tax practitioners should advise their clients against, and help them establish preventative compliance programs to prevent, inserting a non-qualifying person in their chain of ownership. Similarly, the base erosion test requires an initial review by practitioners to determine the level of deductible expense payments to third country residents and the establishment of a compliance program to

⁴¹⁰ *Ibid.*

monitor these payments. And of course, the lack of a definition for “expenses deductible from gross income” will also prove bothersome.

After dealing with the primary challenge of determining whether their clients are qualifying persons, the next task tax practitioners face is determining whether the LOB Article offers any tax planning opportunities for their clients. Initially practitioners must deal with the unsupported assertion in the Protocol’s Technical Explanation that a prohibition against cherry-picking is one of the basic principles of tax treaty interpretation recognized by both contracting states.⁴¹¹ However, in *The Queen v. Crown Forest*, the Canadian Supreme Court stated that there is nothing improper with seeking to minimize tax liability by picking and choosing the international tax regimes most immediately beneficial to the taxpayer.⁴¹² U.S. courts have consistently elucidated similar pronouncements.⁴¹³ Consequently, tax practitioners should make every effort to utilize legal tax planning opportunities available under the Protocol when assisting their clients with minimizing their cross-border taxes.

The qualifying person tests do not provide opportunities for serious tax planning, but there are significant differences between the provisions in the Protocol and the corresponding provisions in other U.S. treaties, and domestic U.S. tax law, which may open the door for some planning opportunities and/or allow taxpayers to escape the application of the LOB Article. Such differences include the lack of a base-erosion rule in

⁴¹¹ See *supra* note 33 at 871 citing the Technical Explanation to the Third Protocol *supra* note 113. This assertion is stated in the Technical Explanation but is not found in the text of the Protocol. An example of what the Technical Explanation considers inappropriate cherry picking would be applying the source rule in the Convention, which declares that copyright royalties paid by a resident of the U.S. to a resident of Canada are sourced in Canada and thus are exempt from withholding tax in the U.S., while simultaneously the taxpayer argues that the royalties are sourced in the U.S. for purposes of calculating the foreign tax credit limit under ITA section 126. See Articles XXII(3) and XXIV(3)(b) of the Convention. This example is taken from Arnold’s article *see supra* note 33 at 885.

⁴¹² See *supra* note 21 at 5397.

⁴¹³ In *Block, II v. U.S.*, 74-1 T.C. 84,356, 84, 360 (1974) the U.S. Tax Court stated that taxpayers have the right to take any lawful step to reduce their taxes, and there is nothing illegal or improper about this action. Similarly, the U.S. Federal Court of Appeals stated that “[t]his and other Courts have repeatedly given recognition to the principle that a taxpayer has the right to reduce its taxes by any legal means and is not required to operate a business in the form most advantageous to the government tax-wise.” *L.W. Tilden, Inc. v. Commissioner of Internal Revenue*, 192 F.2d 704, 708 (1951). Finally in, the famous and often cited case, *Gregory v. Helvering*, the U.S. Supreme Court stated that “[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, cannot be doubted.” 293 U.S. 465, 469 (1935).

paragraph 2(d) of the LOB Article, the test for subsidiaries of publicly-traded corporations.⁴¹⁴ This test, similar to the test in the U.S.-Netherlands treaty and the U.S. branch tax rules, provides benefits to the subsidiary of a publicly-traded company. However, the Netherlands treaty requires that the company seeking treaty benefits must also meet one of two additional tests that measure base erosion. That is, the company either must not be a conduit company or, if it is a conduit company, the company must meet a conduit company base erosion test.⁴¹⁵ There are no additional base erosion tests that apply to Canadian corporations seeking treaty benefits on the basis of ownership by publicly traded corporations. Under, the comparable provision in the branch profits tax rules only a *wholly*-owned subsidiary of a publicly-traded corporation can be a "qualified resident." Consequently, the subsidiary of a publicly traded corporation test in the Protocol is less stringent than U.S. tax policy in this area under both its internal law and existing treaty practices.⁴¹⁶

Second, the testing of aggregate vote and value in the ownership and base-erosion test of paragraph 2(e) without any anti-abuse provisions, such as a rule to prohibit the issuance of shares that achieve disproportionate allocation of rights, provides some planning opportunities.⁴¹⁷ This ownership requirement is not as strict as that contained in the ownership and base erosion test in the last U.S. model income tax treaty, which required 75 percent ownership by residents of the person's country of residence.⁴¹⁸ Further, the ownership requirement in the Protocol differs from the ownership

⁴¹⁴ See *supra* note 91.

⁴¹⁵ Under the Netherlands treaty, a conduit company is one that pays out at least 90 percent of its aggregate receipts as deductible payments, including royalties and interest, but excluding payments made at arm's length for tangible property in the ordinary course of business or services performed in the payor's residence country. A conduit company meets the conduit base erosion test if less than 50 percent of its gross income is paid to non-qualifying persons, or less than 30 percent is paid to non-qualifying persons who are also not residents of an EC member state. *Ibid.* at footnote 29.

⁴¹⁶ *Ibid.*

⁴¹⁷ *Ibid.*

⁴¹⁸ The U.S. Treasury Department has publicly acknowledged that the 1981 U.S. Model Convention is no longer its starting point in treaty negotiations. Treasury officials like to point to the U.S. new treaties with Germany and the Netherlands as examples reflecting current U.S. treaty objectives. David L. Raish and Susan Stone, *The Treaty Making Process*, 46 Tax Lawyer 477, 479 footnote 8 (1993).

requirements in other recent treaties where they concern the application of the vote and value tests to multiple classes of shares. In order for an entity to meet the corresponding provisions in some treaties, such as the U.S.–Germany treaty, appropriate persons must own 50 percent of each class of the entity's shares. Under other treaties, such as the U.S.–Netherlands treaty, the corresponding provision is applied by reference to the aggregate votes and values represented by all classes of shares (as in the Protocol), but anti-abuse provisions are inserted to prevent avoidance of these requirements by issuing classes of shares bearing rights that achieve disproportionate allocations among taxpayers. The Protocol omits any similar anti-abuse provisions. This is important as Canada allows for different classes of shares with independent value and voting rights. Further, Canada, unlike the U.S., allows for multiple voting shares, whereby shares in the same class can have different voting rights and power. Thus, in a case arising under the Protocol abuses under this provision must be addressed by the IRS under paragraph 7 of the LOB article through the use of domestic anti-abuse rules.

Third, the lack of restrictions, such as an ownership or base erosion test, on natural persons, listed companies and their unlisted subsidiaries, estates, not-for-profit organizations and exempt organizations creates the possibility that these qualified persons can be used for treaty shopping purposes. For example, one of these Canadian qualified persons can obtain funds through debt financing from investors in third countries that do not have treaties with the United States. The Canadian qualified person then invests in, or makes loans to, U.S. corporations and receives dividend or interest income that is entitled to reduced withholding rates under the treaty. The qualified person then pays interest on the debt obligations to the third country residents. Of course this is only practical if the U.S. withholding tax is higher than the sum of all Canadian income and withholding taxes. Thus in order to benefit, the third country residents will have to be entitled to reduced withholding rates on the income they receive from the Canadian qualified person as a result of a treaty their country of residence has with Canada. There is no direct prohibition against this activity in the Protocol. However, the qualified person should be concerned about appearing to be a conduit for third country residents earning U.S. source

income.⁴¹⁹ Further, the IRS has recently enacted new conduit financing regulations that specifically prevent the use of conduit financing arrangements created for treaty shopping purposes. These regulations are designed to supplement the LOB provisions in U.S. tax treaties.⁴²⁰

B. Exceptions to the Qualifying Person Requirement:

Although non-qualifying persons are generally not entitled to benefits under the Convention, the Protocol has three limited exceptions for non-qualifying persons. These exceptions are limited as entitlement to treaty benefits is calculated on an item of income by item of income basis, not on the basis of who the shareholders or ultimate beneficiaries are.⁴²¹ The particular income is entitled to treaty benefits not the beneficial owner of the income.

i. The Active Trade or Business Test:

The first exception, in paragraph 3, which provides an alternative to fulfilling one of the qualifying person requirements under paragraph 2 is the *active trade or business* test.⁴²² This test has an eligibility test for residents of Canada who are not qualifying persons under paragraph 2. Unlike the tests of paragraph 2, the active trade or business test does not look solely at the characteristics of the person deriving the income, but also at the nature of the activity engaged in by that person and the connection between the income and that activity. Under the active trade or business test, a resident of Canada, who is not a qualifying person under paragraph 2, deriving income from the United States is entitled to benefits with respect to that income if that person, or a person related to that

⁴¹⁹ Nevertheless, to date the conduit principle has only been applied where the treaty country resident is a corporate entity and it is related to a third country resident. Even if the conduit principle can be extended to cover qualified persons engaged in this activity, the situation described above involves unrelated parties. See *supra* note 633 at 234.

⁴²⁰ See discussion following note 513.

⁴²¹ See *supra* note 551 at 29.

⁴²² If a person qualifies for treaty benefits under one of the tests of paragraph 2 an inquiry will not be made into the qualification for benefits under paragraph 3. Upon satisfaction of any of the tests of paragraph 2, any income derived by the beneficial owner from the U.S. is entitled to treaty benefits. Under paragraph 3, however, the test is applied separately to each item of income. Thus, it is preferable to qualify under paragraph 2 since all of a taxpayer's income will be entitled to treaty benefits. The German-U.S. Tax Treaty was the first U.S. tax treaty to include an active business test. *Ibid.* at 30.

person, is engaged in an active trade or business in Canada and the income in question is derived in connection with, or is incidental to, that trade or business.⁴²³ However, income that is derived in connection with, or is incidental to, the business of making or managing investments will not qualify for benefits under this provision, unless those investment activities are carried on with customers in the ordinary course of the business of a bank, insurance company, registered securities dealer, or deposit-taking financial institution.

Under paragraph 3, income must pass an additional test to qualify for U.S. treaty benefits. The trade or business in Canada must be substantial in relation to the activity in the United States that gave rise to the income in respect of which treaty benefits are being claimed. To be considered substantial, it is not necessary that the Canadian trade or business be as large as the U.S. income-generating activity. The Canadian trade or business cannot, however, represent only a very small percentage of the size of the U.S. activity.⁴²⁴ The substantiality requirement is intended to prevent treaty-shopping. For example, a third country resident may want to acquire a U.S. company that manufactures computers for worldwide markets. However, since its country of residence has no tax treaty with the United States, any dividends generated by the investment would be subject to a U.S. withholding tax of 30 percent. Absent a substantiality test, the investor could establish a Canadian corporation that would operate a small outlet in Canada to sell a few of the computers manufactured by the U.S. company and earn a very small amount of income. That Canadian corporation could then acquire the U.S. manufacturer with capital provided by the third-country resident and produce a very large number of computers for sale in several countries, generating a much larger amount of income. The third-country resident might attempt to argue that the U.S. source income is generated from business activities in the United States related to the computer sales activity of the Canadian parent, and thus the dividend income should be subject to a withholding tax of 5 percent as

⁴²³ This includes any income derived directly or indirectly by the resident person through one or more other persons that are residents of the U.S.

⁴²⁴ The U.S. Netherlands Treaty provides more certainty under its delineated substantiality test. Under that Treaty a trade or business will be considered substantial by reference to the proportionate share of the trade or business in the other state determined by specified ratios of the value of assets used, gross income and payroll expenses in the two countries. U.S.-Netherlands Treaty Article 26(2)(c).

provided by Article X of the Convention. However, the substantiality requirement would not be met in this example, therefore the dividends would remain subject to withholding in the United States at a rate of 30 percent.

Income can be derived by a resident of Canada claiming treaty benefits directly or indirectly through one or more other persons that are residents of the United States. Thus, for example, a Canadian resident could claim benefits with respect to an item of income earned by a U.S. operating subsidiary but derived by the Canadian resident indirectly through a wholly-owned U.S. holding company interposed between the Canadian resident and the operating subsidiary. This language would also permit a Canadian resident to derive income from the United States through one or more U.S. residents that it does not wholly own. For example, a Canadian partnership in which three unrelated Canadian companies each hold a one-third interest could form a wholly-owned U.S. holding company with a U.S. operating subsidiary. The "directly or indirectly" language would allow otherwise unavailable treaty benefits to be claimed with respect to income derived by the three Canadian partners through the U.S. holding company, even if the partners were not considered to be related to the U.S. holding company under the principles of IRC section 482.⁴²⁵

a) Problems with the Active Business Test:

As mentioned above, a person who is a resident of Canada but is not a qualifying person may still be entitled to treaty benefits if they satisfy the active business test. Under this test a person or a related person that is engaged in the active conduct of a trade or business in Canada will be entitled to treaty benefits with respect to income derived from the U.S. in connection with or incidental to that trade or business. Of course one problem with the active business test is that satisfaction of this test only entitles taxpayers to limited treaty benefits, because they are only entitled to treaty benefits for the particular item of income that qualifies. A Canadian resident can earn several types of income in the U.S.

⁴²⁵ See *supra* note 113; Third Protocol, Article 18(3).

and the active business test must be satisfied for each type in order to obtain treaty benefits for every type of income.⁴²⁶

The active business test is intended to cover situations that do not automatically qualify for treaty benefits under the objective tests in Paragraphs 2. However, former Treasury International Tax Counsel Leonard B. Terr, head of the U.S. delegation for four rounds of treaty negotiations on the U.S.–German Tax Treaty, concluded that the active business test will only resolve 90 percent of the situations that do not fit under the objective qualifying person tests in the Protocol.⁴²⁷ The other situations will have to fall within the derivative benefits test or seek a ruling from the U.S. competent authority.⁴²⁸ Other commentators have stated that the test is so complex and vague that in situations where it should be expected that that test could be relied upon, the entity in question will almost always try to obtain comfort in the form of a private letter ruling or U.S. competent authority procedure, no matter how impractical, time consuming or expensive this may be.⁴²⁹

The active business test is not an easy provision to interpret or apply. O'Brien states that the drafting is ambiguous and contains awkward grammar and the use of non-parallel language.⁴³⁰ In referring to the active business test in the German–U.S. treaty, Goossen reports that in practice it was unworkable because, even though the MOU to that Treaty provided guidance as to the use of the test, too many terms were still vague and interpretation of numerous terms remains uncertain.⁴³¹ For example, it is not obvious upon initial reading that a Canadian resident who is applying under this provision for treaty benefits does not have to be carrying on an active trade or business in Canada as long as a person *related* to them is carrying on an active trade or business in Canada.

⁴²⁶ However, this is not really a deficiency with the active business test as it was intentionally designed to operate in this fashion.

⁴²⁷ See *supra* note 1 at 594.

⁴²⁸ *Ibid.*

⁴²⁹ See *supra* note 551 at 32.

⁴³⁰ See *supra* note 20 at 48.

⁴³¹ See *supra* note 323 at 30 & 32.

There is no requirement that the related person be a qualified person or even a Canadian resident.⁴³² While the Technical Explanation is supposed to provide assistance in determining the intent of the active business test, and will be used by U.S. tax authorities and U.S. courts to interpret it, O'Brien states that it will not resolve all its ambiguities.⁴³³ Additionally, the wording of the Technical Explanation diverges from the actual wording in the Protocol. This will create further problems when seeking guidance from the Technical Explanation.⁴³⁴ Consequently, this test will create problems for Canadian taxpayers and their advisors, who would like to qualify under this exception, until there is clarification from U.S. tax authorities.

One of the central problems with this test is that the Protocol and its Technical Explanation do not even define the terms "active trade or business." This makes it difficult for taxpayers to determine if their business falls within the active requirement of this test. To determine the definition of active trade or business, taxpayers and their advisors must look to U.S. domestic tax law or other U.S. tax treaties. The technical explanation to the Netherlands Treaty, whose active business test is virtually identical to that in the Protocol and in the German Treaty, states that the competent authority should refer to IRC section 367(a) to determine whether a trade or business is active.⁴³⁵ The Regulations to this section state that a trade or business is a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit that ordinarily includes the collection of income and the payment of expenses.⁴³⁶ The Regulations further state that a trade or business is active only if the officers and employees of a corporation carry out substantial managerial and operational activities.⁴³⁷ When these conditions are not met, the active business test will not apply.

⁴³² See *supra* note 20 at 48.

⁴³³ *Ibid.*

⁴³⁴ *Ibid.*

⁴³⁵ U.S.-Netherlands Treaty, Technical Explanation, Article 26.

⁴³⁶ IRC Regulations section 1.367(a)-2T(b)(5).

⁴³⁷ IRC Regulations section 1.367(a)-2T(b)(3).

A further problem is that the Protocol does not define “income derived in connection with or incidental to” an active trade or business in the United States. However, the Technical Explanation to the Protocol provides some guidance through the assertion that if the income-generating activity in the United States is “upstream,” “downstream,” or “parallel” to that conducted in Canada it will be considered derived in connection with or incidental to.⁴³⁸ Thus, if the U.S. activity consisted of selling the output of a Canadian manufacturer or providing inputs to the manufacturing process, or of manufacturing or selling in the United States the same sorts of products that were being sold by the Canadian trade or business in Canada, the income generated by that activity would be treated as earned in connection with the Canadian trade or business. The Technical Explanation also 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.⁴³⁹

O’Brien states that vertically integrated operations obviously qualify for treaty benefits as upstream or downstream operations, but there will be difficulty in determining what constitutes a parallel activity.⁴⁴⁰ For example, O’Brien questions whether a Canadian business of importing and distributing golf and tennis equipment and a U.S. business of importing and selling sports equipment as well as manufacturing and distributing outdoor patio furniture are parallel? Or whether oil production is parallel to natural gas production? Or whether a hotel business is parallel to a resort club business?⁴⁴¹

⁴³⁸ This is in contrast to the U.S.–Netherlands Treaty which specifically defines “derived in connection with or incidental to” as an income producing activity that is in a line of business that forms part of or is complimentary to the trade or business or if it facilitates the conduct of the trade or business. U.S.–Netherlands Treaty Article 26(2)(b).

⁴³⁹ The U.S.–Netherlands Treaty defines income as “incidental to” the trade or business if its production facilitates the conduct of trade or business. The MOU to the U.S.–German Treaty includes an example that states that interest earned on income derived from a German business that is retained as working capital and is invested in the U.S. Government securities and other U.S. debt instruments, until need for use in the business, is incidental income and entitled to treaty benefits.

⁴⁴⁰ See *supra* note 20 at 48.

⁴⁴¹ *Ibid.* at 48–9.

Further, the Technical Explanation pronouncement that income is considered incidental if it arises from the short term investment of working capital of a Canadian resident in U.S. securities has been criticized. O'Brien states that this does not give a clear picture of the boundaries of incidental income.⁴⁴² She provides two common situations that demonstrate how a combination of factors will result in the denial of treaty benefits where before they would have been available.⁴⁴³ In the first example, Canco invests its retained earnings that are not needed as working capital in a variety of U.S. and Canadian investments, such as shares, long term bonds and real estate.⁴⁴⁴ The income from these investments is not incidental to the active business because they are of a long term nature. If Canco is no longer a qualifying person, because it failed the base erosion test, and since Canco is not a bank, insurance company, registered securities dealer or deposit-taking institute and the income is not incidental to the Canadian active business, the income earned from U.S. investments which are taxable in the U.S. will be subject to a 30 percent withholding tax.⁴⁴⁵ In O'Brien's second example, she assumes two brothers, both Canadian residents, set up a Canadian company, each owns a one half interest, to invest primarily in Canadian securities and real estate and not more than 15 percent of the investments are in U.S. securities. One of the brothers is transferred by his employer to Chile for an extended period and thus is no longer a Canadian resident. Their investment company ceases to be a qualifying person because it no longer owned and controlled by Canadian residents. The U.S. source dividend and interest income are incidental to the main business of making and managing Canadian investments, thus the brothers could apply for treaty benefits under the active business test. However, since the Canadian company is not a bank, insurance company, registered securities dealer or deposit taking financial institution it cannot qualify under the active business test as the type of active Canadian business that is entitled to treaty benefits. Consequently, the U.S. withholding

⁴⁴² *Ibid.* at 49.

⁴⁴³ *Ibid.* at 49.

⁴⁴⁴ This example is based on the ownership and base erosion example discussed above. *See supra* note 395 and the discussion following.

⁴⁴⁵ *See supra* note 20 at 49.

tax on its U.S. source investments will be 30 percent rather than 15 percent for portfolio dividends and 10 percent for interest.

The ability to satisfy the active-business test if a person related to the entity claiming treaty benefits is conducting the active business may also be problematic. This provision corresponds to provisions found in other recent U.S. treaties, although it is not identical to any of them. For example, where the Protocol provides treaty benefits to an active trade or business in connection with income that is earned or is carried on by a related person, or received indirectly through a related person, the Netherlands treaty provides a more elaborate set of attribution rules and the German test is interpreted in the MOU to the German Treaty to operate under similar principles.⁴⁴⁶ The Technical Explanation indicates that for purposes of the active business test under the Protocol, the term related person has the same meaning as under IRC section 482, which permits the IRS to reallocate items between two or more organizations, trades, or business that are owned or controlled directly or indirectly by the same interests. This definition of related party generally depends on all the facts and circumstances, and does not provide a bright-line test which ensures the certainty that a more mechanically applied attribution rule provides.⁴⁴⁷

Critics have also questioned whether the active business test will cause shareholders in third countries to be dissuaded from pursuing an international acquisition battle in either of the contracting states if they are required to obtain treaty benefit eligibility rulings in advance from the U.S. competent authorities.⁴⁴⁸ For example, if a Canadian holding company with U.S. subsidiaries is the target of takeover attempts, the Canadian bidders could, based on the active business test, table their offers with assurances that treaty benefits would continue to apply subsequent to any successful takeover. However, potential third country acquirers face the uncertainty of the

⁴⁴⁶ See *supra* note 91.

⁴⁴⁷ *Ibid.* Although, the lack of a bright line definition of a related person may be problematic for some taxpayers, for others it may provide tax planning opportunities that otherwise would not exist in the face of an elaborate set of attribution rules.

⁴⁴⁸ See *supra* note 324 at 999.

competent authority ruling process, which may inhibit a competitive bidding contest with Canadian bidders.⁴⁴⁹

In my opinion the active business test in the Protocol is also objectionable as it does not include certain provisions that are in the Netherlands Treaty that provide treaty benefits to certain *bona fide* entities. First, the active business test in the Protocol does not make any provision for Canada's membership in NAFTA, while the test in the Netherlands Treaty recognizes its membership in the EC.⁴⁵⁰ Paragraph 2(h) of Article 26 in the Netherlands Treaty recognizes that business operations in other EC countries can be taken into account in determining whether business operations are considered substantive or whether the income is incidental to the trade or business. Goossen concludes that the ability to take into account the business operations in other EC countries is essential for a small country like the Netherlands.⁴⁵¹ Similarly, this ability would be essential for Canada because it also has a relatively small economy. The active business test in the Protocol should have provided that business operations in all present and future NAFTA countries can be taken into account when determining whether the taxpayer's business operations are substantial or incidental in comparison to the U.S. business operation. Such a provision would prevent disqualification under the active business test for Canadian corporations that carry on operations throughout North America, and throughout South America if NAFTA is expanded into the Southern hemisphere.

Second, the active business test in the Netherlands LOB Article provides a safe harbour rule for determining which business operations qualify as substantial by listing certain ratios, with respect to asset value, gross income, and payroll expenses, that if met qualify the business operation as substantive. This safe harbour removes the subjectivity of the substantiality portion of the active business test which, as discussed, requires a

⁴⁴⁹ *Ibid.* at 999-1000.

⁴⁵⁰ Unfortunately, the active business test in the Mexico LOB Article also does not provide for recognition of business operations in NAFTA countries. Of course I recognize that NAFTA and EC membership are not equivalent in terms of the benefits conferred on their members. However, while they are not parallel situations, Canada should have insisted on the inclusion of a similar provision in the Protocol.

⁴⁵¹ *See supra* note 551 at 44.

comparison of the proportionate share of business in the other state, the nature of activities and the contribution of the activities to the conduct of the trade or business. The utility of this safe harbour is enhanced by the aforementioned ability to take EC business operations into consideration when calculating whether the safe harbour has been met. Although, this portion of the Netherlands' active business test has been criticized as complex, I believe that this objection is overcome by the certainty it provides over a test, such as in the Protocol, which only includes a subjective and undefined reference to "substantial."

Finally, the U.S.-Netherlands Treaty includes an additional active business test for headquarters holding companies. Many Dutch corporations were, and still are, formed as holding companies explicitly for the purposes of managing international investments and therefore the Dutch were reluctant to include an exclusion of the business of managing investments from their active business test, as the German, Mexico and Canadian treaties did. As these corporations would be denied treaty benefits if they failed to meet any of the other tests, the Dutch succeeded in including a headquarters/holding company active business test in their treaty.⁴⁵² Article 26(3) of the Netherlands Treaty provides treaty benefits to headquarters companies which furnish overall supervision and administration of a corporate group resident in at least five countries and no more than 25 percent of the group's income, which is derived in connection with, or is incidental to its active business, is derived from the U.S. Through the headquarters provision, multinational investment corporations resident in the Netherlands are entitled to treaty benefits. While Canada is not a favoured location, on the scale of the Netherlands, for holding companies managing international investments. Canadian negotiators should still have demanded a similar provision in the Protocol in recognition of Canada's and the U.S. close economic ties, the lack of treaty shopping that occurs between them and in recognition of the influx of business immigrants to Canada who no doubt utilize international holding companies to manage their offshore investments.⁴⁵³

⁴⁵² See *supra* note 633 at 249.

⁴⁵³ While the Protocol does not contain a similar provision as in the U.S.-Netherlands treaty, a Canadian holding company may still be entitled to treaty benefits. The MOU to the U.S.-German Treaty states that the active

b) *Tax Planning Considerations:*

The active business test in Paragraph 3 will prove to be the troublesome for tax practitioners because of its subjective criteria. The active business test refers to terminology such as 'active conduct', 'in connection with or incidental to' and 'substantial.' These terms are not defined in the Protocol and tax practitioners should refer to the Technical Explanation which provides some limited guidance as to what is considered to be acceptable. However, as discussed above, the Technical Explanation is not completely satisfactory and practitioners may have to refer to U.S. domestic tax law or other U.S. tax treaties with similar tests to determine if their clients satisfy the active business test. Also the subjectivity of these terms may lead to inconsistent interpretation by the U.S. competent authorities.

Fundamentally, tax practitioners must realize that the business activity in Canada must be 'substantial' in relation to the U.S. activity that produces U.S. source income, and a functional relationship between the active business in Canada and the business in the U.S. must exist.⁴⁵⁴ Problems may arise with diversified conglomerates or foreign controlled diversified conglomerates as they may have trouble satisfying the substantiality and/or functional relationship portions of the active business test.⁴⁵⁵ Also, third-country bidders in international acquisitions may be forced to rely on subjective competent discretion under Paragraph 6, which may reduce their bidding power and eliminate any element of surprise with which they may enter a particular acquisition contest.⁴⁵⁶

The U.S. Treasury Department provided several examples in its Technical Explanation to clarify the active business test in the LOB of the German-U.S. Tax Treaty. The active business test in the German Treaty is very similar to that in the Protocol and

business test in that treaty does not deny treaty benefits to a German holding company that earns income from its U.S. subsidiary when the activity is carried on in Germany through a German subsidiary. *See supra* note 291 at 249. This is because income that is earned by one related party and is paid by another related party to the holding company is entitled to treaty benefits. Thus a Canadian holding company will be entitled to treaty benefits if it has a subsidiary in Canada that earns active business income and that subsidiary owns a subsidiary in the U.S.

⁴⁵⁴ *See supra* note 324 at 1003.

⁴⁵⁵ *Ibid.*

⁴⁵⁶ *Ibid.*

these examples are useful in providing guidance to tax practitioners and their clients.⁴⁵⁷ In the first example, the active business test is met where a German resident company is owned by three persons, each residing in a different third country, and the company carries on an active manufacturing business in Germany. The company has a wholly owned subsidiary in the U.S. that is engaged in selling the output of the German parent. The active business in Germany is substantial in relation to the activities in the U.S. and interest and dividend payments to the German parent are eligible for treaty benefits because the U.S. income is derived in connection with or is incidental to the active German business.⁴⁵⁸ This example confirms that ownership of the entity seeking benefits is irrelevant for the active business test. As long as the entity meets the criteria of the active business test it is immaterial whether the beneficial owners are qualifying person or not. Therefore, a Canadian resident corporation can be established to obtain treaty benefits for third country residents as long as they have a substantial active business in Canada and the activity in the U.S. is incidental or in connection with the Canadian activity.

In second example, the active business test is met where the German based activities are conducted by a German subsidiary of the German parent of the U.S. subsidiary. Treaty benefits are granted since the business relationship and substantiality test are met by the related company.⁴⁵⁹ This example establishes that a parent corporation that may be a holding company can insert a subsidiary in its country of residence which conducts the substantial active business activity. This way the parent will enjoy treaty benefits on its U.S. source income, although it is not engaged in the active conduct of a trade or business.

In the third example, a German resident company is owned by three persons, each resident in a different third country, the company is the worldwide headquarters and parent of an integrated international business carried on through subsidiaries in many

⁴⁵⁷ See Article 28 of the German-U.S. Tax Treaty in Appendix Three.

⁴⁵⁸ These examples are reported in Streng's article, *supra* note 201 at 37. The Technical Explanation of the 1989 U.S.-German Income Tax Treaty, Aug. 29, 1989, is *reprinted in* 2 Tax Treaties (CCH) ¶ 3255 (Feb. 1993).

⁴⁵⁹ *Ibid.* at 37-8.

countries. The U.S. and German subsidiaries manufacture products that are part of the group's product line. Treaty benefits will be granted because the U.S. income is derived in connection with or is incidental to the German active business.⁴⁶⁰ This example substantiates that while the German LOB Article, like the one in the Protocol, does not have a headquarters clause treaty, benefits may be granted for headquarters operations under the active business test. Since the active business test in both treaties are virtually identical a strong argument can be made that the active business test provides treaty benefits to Canadian resident corporations that are the worldwide headquarters for an international business.

In the fourth example, a third country resident established a German corporation for the purpose of acquiring a large U.S. manufacturing company. The sole business activity of the German corporation, other than holding the stock of the U.S. company, is the operation of a small retailing outlet that sells products manufactured by the U.S. company. The German corporation will not be entitled to treaty benefits paid by the U.S. company to the German corporation because the substantiality test is not met.⁴⁶¹ This example verifies that the active business must be substantial in relation to the U.S. business. At the very least, the active business must be larger than the U.S. business.

In example five, a German corporation, a French corporation and a Belgian corporation form of a joint venture corporation as equal shareholders organized in Germany to manufacture a product in a developing country. The joint venture corporation engages in the an active manufacturing business in Germany. Income from that business is invested in U.S. government securities and other U.S. debt instruments until it is needed for use in the business. The interest on these instruments is entitled to treaty benefits since income from the short term investment of working capital is incidental to the business in Germany.⁴⁶² This example confirms that conducting an active U.S.

⁴⁶⁰ *Ibid.* at 38.

⁴⁶¹ *Ibid.*

⁴⁶² *Ibid.* at 39-40.

business in connection with the substantial active German/Canadian business is not necessary if the U.S. income producing activity is incidental to the active business.

ii. *Derivative Benefits Test:*

The second exception to the general rule that non-qualifying persons are not entitled to treaty benefits is the *derivatives benefits test* in Paragraph 4. This complex test provides limited treaty benefits with respect to U.S. source dividends, interest, and royalties beneficially owned by a resident of Canada who is not a qualifying person. A corporation that is a resident of Canada is entitled to the benefits under Articles X (Dividends), XI (Interest) and XII (Royalties) if:

- a) its shares that represent more than 90 per cent of the aggregate vote and value represented by all of its shares (other than debt substitute shares) are owned, directly or indirectly, by persons each of whom is a qualifying person, a resident or citizen of the United States or a person who
 - i. is a resident of a country with which the United States has a comprehensive income tax Treaty and is entitled to all of the benefits provided by the United States under that Treaty;
 - ii. would qualify for benefits under paragraphs 2 or 3 if that person were a resident of Canada; and
 - iii. would be entitled to a rate of United States tax under the Treaty between that person's country of residence and the United States, in respect of the particular class of income for which benefits are being claimed under this Treaty, that is at least as low as the rate applicable under this Treaty; and
- b) the amount of the expenses deductible from gross income that are paid or payable by the company 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 per cent of the gross income of the company for that period.

A derivative benefits provision is not generally found in U.S. treaties. However, this rule was included in the Convention because of the special economic relationship between the United States and Canada and the close coordination between the tax

administrations of the two countries.⁴⁶³ Under the derivative benefits rule, a Canadian resident company may receive the benefits of Articles X (Dividends), XI (Interest), and XII (Royalties), even if the company is not a qualifying person and does not satisfy the active trade or business test of paragraph 3. To qualify under this paragraph, the taxpayer must satisfy both the base erosion test under subparagraph (e) of paragraph 2 and an ownership test.

The ownership test in the derivative benefits provision requires that shares, other than debt substitute shares, representing more than 90 percent of the vote and value of a Canadian company be owned directly or indirectly by either, or a combination of, (i) qualifying persons, or U.S. citizens or residents, or (ii) other persons that satisfy each of three tests. The three tests that must be satisfied by these other persons are as follows. First, the person must be a resident of a third State with which the United States has a comprehensive income tax treaty and be entitled to all of the benefits under that treaty.⁴⁶⁴ Second, the person must be a person that *would* qualify for benefits with respect to the item of income for which benefits are sought under one or more of the tests of paragraph 2 or 3 of this treaty, *if* the person were a resident of Canada and, for purposes of paragraph 3, the business was carried on in Canada.⁴⁶⁵ The third requirement is that the rate of U.S. withholding tax on the item of income in respect of which benefits are sought must not be greater than the rate of withholding under the treaty between the person's country of residence and the United States.

⁴⁶³ See *supra* 113, Technical Explanation, Article 18. There is, nevertheless, a derivative benefits test in the Netherlands and Mexico tax treaties, but not in the German treaty nor the U.S. Model Convention.

⁴⁶⁴ If the person fails to satisfy the LOB Article, if any, in its state of residence's tax treaty with the U.S. then treaty benefits will not be granted under the derivative benefits test. Qualification for benefits under only an active trade or business test does not suffice for these purposes, because that test grants benefits only for certain items of income. The taxpayer must be entitled to all the treaty benefits under the tax treaty between its country of residence and the U.S. Thus, if there is LOB article in that treaty the taxpayer is required to be a qualifying person.

⁴⁶⁵ For example, a person resident in a third country would be deemed to be a person that would qualify under the publicly traded test of paragraph 2 of the Protocol if the principal class of its shares were substantially and regularly traded on a stock exchange recognized either under the treaty between the United States and Canada or under the treaty between the United States and the third country. Similarly, a company resident in a third country would be deemed to satisfy the ownership/base erosion test of paragraph 2 under this hypothetical analysis if, for example, it were wholly owned by an individual resident in that third country and most of its deductible payments were made to individual residents of that country.

The following example illustrates the operation of this test. Assume Canco, a Canadian resident company, has its shares held in the following proportions; USco owns 45 percent, a Swiss resident individual owns 50 percent and Senegalco owns 5 percent.⁴⁶⁶ Canco is not a qualifying person because only 45 percent of its shares are owned by qualifying persons, the U.S. resident USco. Thus, Canco is not entitled to the lower withholding rate provided by the Convention, and if it receives dividends from the U.S., it will be subject to a 30 percent withholding rate. However, the exception under the derivatives benefits test allows Canco to obtain the lower treaty rate, 6 percent in 1996 and 5 percent in 1997, since Switzerland has a tax treaty with the U.S. with an equivalent dividend withholding rate as the Convention and if the Swiss individual were a resident of Canada she would qualify for treaty benefits under paragraph 2(a), which would result in 95 percent of Canco's shares owned by eligible persons.

The rationale behind the derivatives benefits test is that Canadian companies that are not qualified persons, as a result of not being controlled by persons who are Canadians or U.S. citizens, are nonetheless entitled to low withholding rates because the persons who control the corporation are entitled to the same or lower withholding rate under a treaty with the U.S. and their country of residence.⁴⁶⁷ Thus, if the person would have been entitled to low withholding rates if they had invested directly in the U.S. then they will be entitled to equally advantageous treatment as a result of investing in the U.S. through a Canadian corporation. For instance, the derivative benefits test allows a company resident in Canada that is owned by a company resident in a third country to obtain limited treaty benefits if the foreign company was a qualifying person because its shares were regularly and substantially traded on a recognized exchange and the Canadian company meet the base erosion test.⁴⁶⁸

An example where the derivative benefits rule provides treaty benefits, illustrated in figure six, would be where a Netherlands company, owned by members of a family of

⁴⁶⁶ This example is adapted from an example provided by Gelardi, *supra* note 112 at 60.

⁴⁶⁷ See *supra* note 20 at 50.

⁴⁶⁸ This example is taken from Russell's Article, *supra* note 16 at 981.

Dutch residents, has a wholly owned Canadian subsidiary, Canco. Canco owns Canadian real estate and other investments and has a wholly owned U.S. subsidiary, USsub.⁴⁶⁹

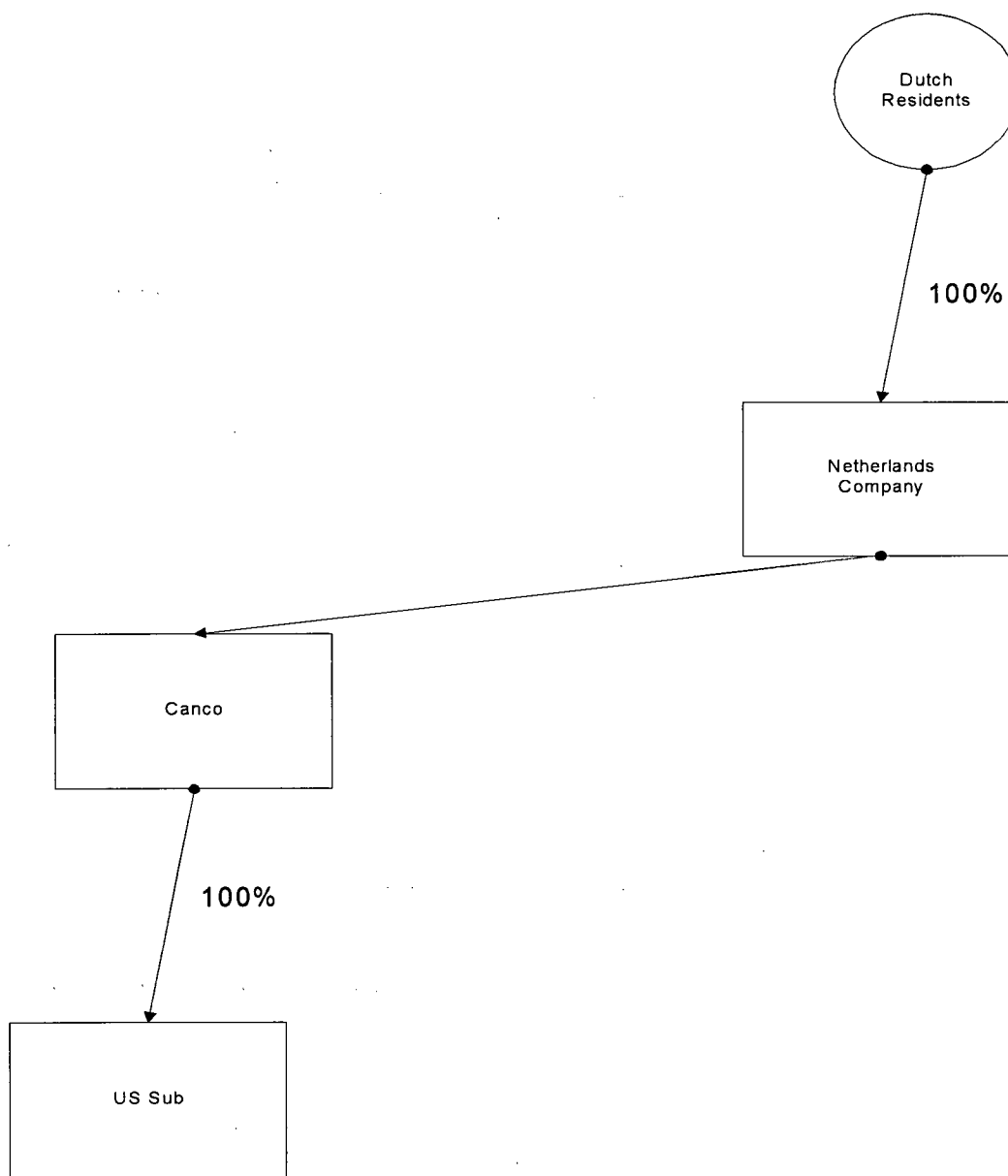


Figure 6: Derivative Benefits Examples

The Netherlands has a comprehensive tax treaty with the U.S., under which the maximum rate of withholding for direct dividends is 5 percent. The Netherlands

⁴⁶⁹ This example is taken from O'Brien's Article, *supra* note 20 at 50.

corporation in this example would be entitled to the 5 percent rate if it directly owned the U.S. subsidiary. Thus, under the derivative benefits test Canco is entitled to the reduced rate of 5 percent under the Protocol on its dividend income from USsub since Canco is owned by the Netherlands corporation.

a) Problems with the Derivative Benefits Test:

While the derivative benefit test provides another avenue for non-qualifying persons, particularly Canadian holding companies or investment companies that are not controlled by qualifying person or U.S. residents or citizens, to obtain treaty benefits with respect to dividends, branch profits, interest and royalties, it is not without its problems. First, persons attempting to qualify under this provision must meet a high threshold, the 90 percent ownership test. As discussed, 90 percent of the vote and value of the shares of a company must be owned by qualifying persons or residents or citizens of the U.S. Alternatively, 90 percent of the vote and value can be owned by persons who are residents of a country the U.S. has an income tax treaty, under which they are entitled to treaty benefits. Further, they would, *if* residents of Canada, be entitled to treaty benefits, either as qualifying persons or under the active business test, and they are entitled to a withholding tax rate under the treaty between their country of residence and the U.S. that is at least as low as the rate in the Canada-U.S. Tax Treaty. Additionally, a base erosion test, whereby the amount of deductible expenses paid or payable to non-qualifying persons or persons who are not residents or citizens of the U.S. must be less than 50 percent of the company's gross income for that period, has to be met. Not only is this test very complex, the threshold that must be met to qualify may be so high that it will be difficult, if not impossible, to qualify.

While the derivative benefits test in the Protocol is similar to comparable provisions in U.S. tax treaties with the Netherlands and Mexico, the U.S. associate international tax counsel stated that the test in the Protocol is superior as it is the only provision of its type in U.S. tax treaties that grants derivative benefits without requiring

any local (Canadian) ownership.⁴⁷⁰ However, I disagree with this statement. The test in the U.S.-Netherlands treaty provides treaty benefits for dividends, branch profits, interest and royalties if, in addition to a standard base erosion test, more than 30 percent of the shares are owned by qualified persons resident in the Netherlands and more than 70 percent of the shares are owned by residents of EC member states which have a tax treaty with the U.S.⁴⁷¹ Under the U.S.-Mexico Treaty a corporation satisfies the derivative benefits test if more than 30 percent of its shares are owned by persons resident in Mexico or the U.S., who are entitled to treaty benefits under the U.S.-Mexico Treaty. Additionally, more than 60 percent of the shares are owned by persons resident in a NAFTA member state, which has a tax treaty with the U.S. Finally, a base erosion test must be met, where less than 70 percent of gross income is used to satisfy liabilities to non-qualifying persons and less than 40 percent is used to satisfy liabilities to non-qualifying persons who are also not a resident of a NAFTA member state.

The lack of a local Canadian ownership requirement in the Protocol's derivative benefit test does not result in a real difference in effect between that test and the tests in the U.S.-Netherlands and U.S.-Mexico treaties. It can, in fact, be argued that the tests in the U.S.-Netherlands and U.S.-Mexico treaties are superior as a result of their recognition of these countries respective memberships in the EC and NAFTA. Furthermore, these tests have lower ownership thresholds. In addition, both these derivative benefits tests provide treaty benefits for branch profits as well as dividends, interests and royalties, while the Protocol is limited to dividends, interest and royalties.

The tests in the U.S.-Netherlands Treaty include a clear recognition of the Netherlands participation in the EC by providing derivative benefits if residents of EC countries own shares of the corporation seeking treaty benefits.⁴⁷² Similarly the derivative benefits test in the U.S.-Mexico Treaty provides derivatives benefits if residents

⁴⁷⁰ See *supra* note 271 at 24:8

⁴⁷¹ See Appendix Four, Article 26(4) of the U.S.-Netherlands Tax Treaty.

⁴⁷² Provision is made for NAFTA residents in the general derivative benefits test in Article 17 paragraph 1(g) and in the indirect stock exchange derivative benefits test in paragraph 1(d)(iii).

of NAFTA countries are beneficial owners of the corporation's shares. Additionally, the ownership requirements in these tests are significantly lower than that in the Protocol. While the Protocol requires 90 percent of the shares to be held by qualifying persons or others, the test in the U.S.-Netherlands Treaty reduces this to a 30 percent requirement for qualifying person resident in the Netherlands and a requirement that more than 70 percent be owned by non-qualifying persons who are resident in EC states. Therefore, while 30 percent of the corporation's shares can be held by persons who do not meet the requirements of the derivative benefits test, this figure is only 10 percent in the Protocol. Analogously, the test in the U.S.-Mexico Treaty only requires 30 percent of the shares to be held by qualifying persons and more than 60 percent held by non-qualifying persons who are residents of a NAFTA country. Thus, under the provision in the U.S.-Mexico Treaty, derivative benefits will be granted even if 39 percent of the shares are held by persons who do not meet its requirements. Additionally, the asserted utility of the lack of a local ownership requirement in the Protocol has been reduced as the IRS has begun to administratively expand the derivative benefits tests in other tax treaties by providing treaty benefits to entities that do not satisfy the mechanical requirements of the derivative benefits test.⁴⁷³

In addition to the difficulty in meeting the derivative benefits test high threshold, the derivative benefits test can also lead to anomalous results in some situations. First, a Canadian resident company could satisfy the active business test, but fail to satisfy the derivative benefits test. For example, a company, that is not a qualifying person, could meet the active business test and enjoy treaty benefits for a particular item of income, including for example branch profits from a U.S. subsidiary derived in connection with a substantial Canadian active business. But the company will not necessarily be entitled to

⁴⁷³ See discussion in note 254 noting that the IRS is providing treaty benefits to U.K. mixer companies by accepting that they satisfy the *concept* behind the derivative benefits test, although not its mechanical requirements.

Additionally, the LOB in the German Treaty does not have a derivative benefits test at all. However, the MOU to the U.S.-German Treaty states that discretionary authority should be exercised with particular cognizance of the developments in and objectives of international economic relationships such as the EC and NAFTA. *See supra* note 323 at 37. Consequently, while there is no similar statement in the Protocol nor its Technical Explanation, it can be hoped that the U.S. competent authority will apply their discretionary authority to Canadian entities with similar equanimity.

treaty benefits for the interest income it earns from a loan to a U.S. corporation, unless it also independently satisfies the derivative benefits test.⁴⁷⁴ This is the case because the active business test provides treaty benefits only for that particular item of income that is earned in connection or incidental to the substantial active Canadian business income. Thus the benefits of the Treaty would not be available to all of the Canadian company's U.S. source dividend, interest and royalty income, unless it also passed the derivative benefits test.

The second anomalous result arises when a Canadian resident corporation does not meet the derivative benefits test as a result of failing to satisfy the requirement of having a rate of withholding in the tax treaty between the non-qualifying person and the U.S. at least as low as the rate in the Protocol. If the rate of withholding tax in the treaty between the non-qualifying person's country residence and the U.S. is, for instance, 10 percent and in the rate in the Protocol is 5 percent, the Canadian resident corporation would fail the derivative benefits test and the applicable rate of withholding would be the maximum withholding rate in the U.S. of 30 percent.⁴⁷⁵ This is an anomalous result as the applicable rate if the derivative benefits test is not met is the maximum U.S. rate of withholding, not the rate in the treaty between the U.S. and the non-qualifying person's country of residence. The rationale behind the derivative benefits test is to provide treaty benefits to otherwise non-qualifying person if their country of residence has a treaty with the U.S. Applying the maximum withholding rate in a situation such as the one described is a punitive result since the third country resident is entitled to a reduced rate of withholding under their treaty with the U.S. They should, thus, be entitled to that rate under the Protocol even if they do not meet the derivative benefits test. I believe this should be the case because there is no danger of treaty shopping if third country residents of U.S. treaty partners are granted the withholding rate they are entitled to in their own treaty with the U.S.

⁴⁷⁴ *Ibid.*

⁴⁷⁵ *Ibid.*

The third anomaly is the uncertainty that arises when one queries whether multinational corporations with Canadian and U.S. subsidiaries qualify under the derivative benefits test. O'Brien provides an illustrative example, depicted in figure seven, that demonstrates the complexity and difficulties multinationals may encounter in seeking to qualify under this test.⁴⁷⁶

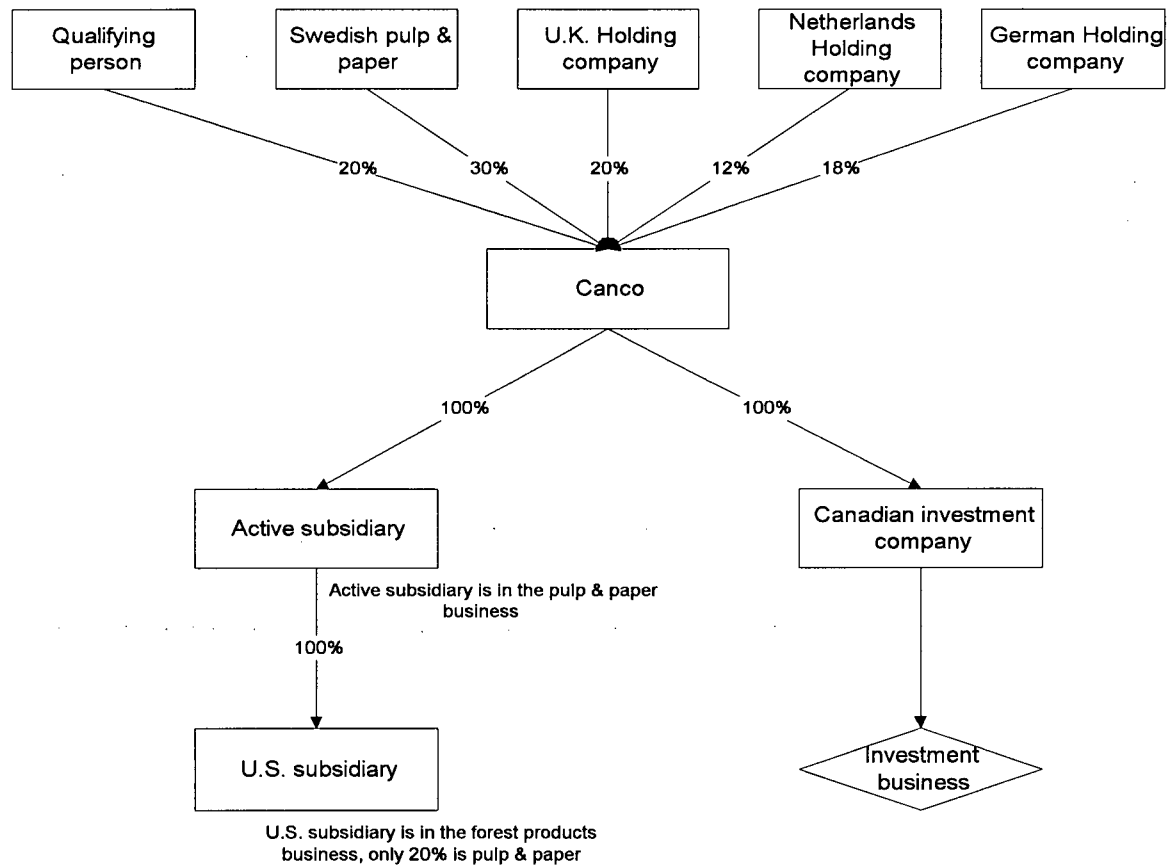


Figure 7: The Derivative Benefits Test in a Multinational Context:

In this example, Canco is a private corporation resident in Canada. Its shares are held 20 percent by qualifying person and 80 percent by corporations resident in the Netherlands, U.K., Sweden and Germany. The Swedish shareholder holds 30 percent of Canco's shares and it carries on an active pulp and paper business in Sweden. The

⁴⁷⁶ The example and figure are adapted from O'Brien's article, *supra* note 20 at 50– 53.

Netherlands, German, and U.K. shareholders are subsidiaries of multinational companies. These subsidiaries do not carry on an active business, but only hold the shares of Canco for their parent companies. Further, the parent companies also do not carry on any active businesses, but only hold the shares of their numerous subsidiaries that carry on businesses in different countries. Canco has two Canadian subsidiaries, Activesub and CanInvest. Activesub carries on an active pulp and paper business in Canada. Activesub has a U.S. subsidiary that carries on an active forest products business, 20 percent of which is pulp and paper. Canco's other subsidiary is CanInvest which carries on an investment business, but it is not a bank, insurance company, registered securities dealer or deposit taking financial institution.

Canco, and its subsidiary Activesub, are not qualifying persons as Canco does not meet any of the qualifying person tests and therefore they are not entitled to treaty benefits. The U.S. source income of CanInvest also will not be eligible for treaty benefits under the active business test because it is not connected with or incidental to an active business carried on in Canada by CanInvest or its related persons, Canco or Activesub. The dividend income that Activesub receives from USsub may also fail to qualify for treaty benefits under the active business test because although their businesses are related, they may not be similar enough to be considered parallel. USsub's pulp and paper business represents only 20 percent of its overall forest products business and it is not clear whether the U.S. competent authorities would consider USsub to be manufacturing or selling the same sorts of products as those being manufactured or sold by Activesub in Canada.⁴⁷⁷ Thus Canco, Activesub and CanInvest will have to rely on the derivative benefits test in order to obtain treaty benefits for the dividend, interest or royalty income they receive from the U.S.

In order to qualify under the derivative benefits test, the ownership and base erosion tests must be met. Under the ownership test 90 percent of the corporation's

⁴⁷⁷ However, O'Brien states that it may be possible to argue that the proportion of Activesub's dividend income from USsub that represents the profits of the pulp and paper business should be entitled to reduced withholding rates. See *supra* note 20 at 52. However, it is unclear whether this is possible since the Protocol does not address this issue.

shares must be held by persons who are residents of a country which has a tax treaty with the U.S. under which they are entitled to benefits and they would be qualifying persons if they were a residents of Canada and they are entitled to a rate of withholding under their tax treaty with the U.S. that is no higher than the rate in the Protocol. To determine if the derivative benefits test has been met in this example, first the U.S. tax treaties with Sweden, the U.K., Germany and the Netherlands will have to be reviewed in order to ascertain whether those corporations are entitled to all the benefits under their tax treaty with the U.S. The U.S.–Netherlands Tax Treaty and the U.S.–Germany Tax Treaty contain LOB articles that are very similar to the LOB article in the Protocol. However, a Canadian tax advisor will have to review these articles, as well as any related technical explanations and case law, very carefully to ensure that the corporations in question are qualifying persons and are entitled to all the benefits under those treaties.⁴⁷⁸ The U.S.–U.K. Treaty has an anti–treaty shopping article that it is not similar to the LOB provision and the U.S.–Sweden Treaty does not have any anti–treaty shopping provisions. Again the Canadian resident’s tax advisor will have to review these treaties to determine if the entities which own Canco are entitled to all the treaty benefits under their treaties with the U.S. This, of course, will be a time consuming task, if not difficult one, for an advisor who is not familiar with these treaties.

Assuming that each of foreign shareholders of Canco are entitled to all the benefits under their respective treaties with the U.S., the second step is to determine if each of the foreign shareholders *would* qualify for treaty benefits *if* they were a resident of Canada and they carried on the business, that they are currently are engaged in their country of residence, in Canada as either a qualifying person or under the active business test. In this situation assume that the foreign shareholders of Canco would be qualifying persons under the Convention if they were resident in Canada. If they were not qualifying persons then it would be necessary for each them, or a company related to them, to carry on an active business, such as a substantial pulp and paper business, in their country of residence. Only the Swedish shareholder qualifies in this fashion.

⁴⁷⁸ See *supra* note 20 at 52.

The final test that the foreign shareholders of Canco must meet is whether the withholding tax in the treaty between their country of residence and the U.S. is no higher than that in the Protocol. This prerequisite also requires a close review of aforementioned foreign tax treaties, as well as the foreign shareholders degree of shareholding in Canco. A low direct dividend withholding rate may require different levels of shareholding under different tax treaties. The Protocol requires ownership of at least 10 percent of a corporation's shares in order for entitlement to a reduced 5 percent withholding rate, otherwise the rate will be 15 percent. Each of the treaties being reviewed must provide an equivalent to or lower direct dividend withholding rate than the 5 percent rate in the Protocol, and each shareholder must have sufficient shareholdings to qualify for that rate. Under the U.S.-Swedish Treaty, to be entitled to the low direct dividend rate of 5 percent the Swedish resident corporation must own, either alone or with no more than two other corporations, at least 50 percent of the shares of Canco. Under the U.S.-Netherlands Treaty, the Netherlands shareholder must own 25 percent of Canco's shares to qualify for the 5 percent withholding rate. Thus, in this hypothetical example the Swedish and Netherlands shareholders do not qualify under the derivative benefits test as they do not own sufficient shares to qualify for a rate of withholding at least as low as that in the Protocol. Since 90 percent of the shareholders of Canco must meet all the requirements of the derivative benefits test, Canco does not qualify for the limited treaty benefits available under this test.

The above example demonstrates the adverse impact the LOB Article can have on a variety of Canadian resident corporations that were entitled to treaty benefits prior to the Protocol and are not currently engaged in treaty shopping. They will be denied treaty benefits unless they restructure their share ownership by foreign entities. The alternative to taking corrective measures to counter the LOB Article is to pay the full U.S. withholding tax of 30 percent. In the example presented, treaty shopping, which the LOB article is intended to prevent, was not occurring as all the entities involved were resident in countries that have comprehensive tax treaties with the U.S. with rates of withholding equivalent to that in the Protocol. However, the multinational character of Canco's

ownership resulted in the denial of treaty benefits. The failure to qualify for treaty benefits resulted from the interaction of different requirements in various U.S. tax treaties and because the direct dividend provision in the Convention has a lower threshold than similar provisions in other U.S. tax treaties.⁴⁷⁹

b) *Tax Planning Considerations:*

As I have already discussed, the derivative benefits test will be a difficult test to apply from the tax practitioner's perspective. This test requires the practitioner to first determine if a client is considered to be a resident under another U.S. tax treaty. The practitioner is then required to determine if their client, assuming they are a resident of Canada, would be a qualifying person under Paragraph 2 or satisfied the active business test under Paragraph 3. Finally, the practitioner is required to determine if under that foreign tax treaty, which they may or may not be familiar with, their client is entitled to all its benefits and the withholding tax rate is not greater than the rate applicable under the Canada-U.S. Tax Treaty.

However, the derivative benefits test does offer some tax planning opportunities. Streng speculates that the derivatives benefits test in LOB articles can be used to obtain eligibility for treaty benefits when they otherwise would not be available.⁴⁸⁰ Streng argues that a taxpayer cannot obtain treaty benefits by arguing that substance triumphs over form in defining the income tax consequences of a transaction. However, this rule should not prevail when the ultimate owner of a conduit entity is in a tax treaty jurisdiction but the conduit is in a third non-treaty jurisdiction and is used as an investment vehicle into the U.S.⁴⁸¹ For example, assume Canadian residents establish a Hong Kong corporation which is used as an investment vehicle into the U.S. and the Hong Kong corporation is more than a mere dummy corporation, because it has some commercial purpose such as

⁴⁷⁹ *Ibid.* The Convention only requires a shareholding of 10 percent in order for a shareholder to be entitled to the lowest dividend withholding rate of 5 percent. As mentioned above, the comparable provision in the U.S.-Swedish Treaty requires a shareholding of 50 percent in order to receive this rate, and the Netherlands Treaty requires ownership of 25 percent of a corporation's shares.

⁴⁸⁰ See *supra* note 201 at 46-7.

⁴⁸¹ *Ibid.*

avoiding Canadian regulatory restrictions.⁴⁸² When interest and dividends are distributed to the Hong Kong corporation from the U.S. they will be subject to a 30 percent withholding rate since Hong Kong does not have a tax treaty with the U.S. Streng argues the Canadian owners should be able to argue that tax treaty benefits under the Canada–U.S. Tax Treaty should apply to reduce the 30 percent withholding rate to the reduced rates under the Protocol because, although the intermediary corporation is in a non–treaty country, the ultimate beneficial ownership is in Canada and the intermediary is merely a conduit.⁴⁸³ Of course, since a situation, such as the one just described, is not explicitly provided for in the Protocol, taxpayers and their advisors would be well cautioned to seek a competent authority determination as to their entitlement to treaty benefits. This is the subject of the next section of this thesis.

iii. Competent Authority Discretion:

The third and final exception to the Protocol's basic dictum that only qualified persons are entitled to treaty benefits is Paragraph 6. It provides that when a resident of Canada derives income from the United States and is not entitled to treaty benefits under any of the enumerated provisions in the Article, benefits may, nevertheless, be granted at the discretion of the U.S. competent authority.⁴⁸⁴

Thus, a resident of Canada may request the U.S. competent authority (the IRS) to determine that it was not created nor does it exist for the principal purpose of obtaining treaty benefits that it would otherwise not be entitled to, or that it would be inappropriate to deny it treaty benefits. In making a determination under paragraph 6, the competent authority will take into account all relevant facts and circumstances relating to the person requesting the benefits. In particular, the competent authority will consider the history, structure, ownership, including ultimate beneficial ownership, and operations of the person. In addition, the competent authority is to consider: (1) whether the creation and

⁴⁸² Hong Kong is considered a tax haven and does not have a tax treaty with the U.S. This example is adapted from Streng's example, *Ibid.* at 47.

⁴⁸³ *Ibid.*

⁴⁸⁴ See Appendix One; Third Protocol, Article 18(6).

existence of the person did not have as a principal purpose obtaining treaty benefits that would not otherwise be available to that person; and (2) whether it would not be appropriate, in view of the purpose of the Article, to deny benefits. Paragraph 6 specifies that if the U.S. competent authority determines that either of these two standards is satisfied, benefits *must* be granted. Treaty benefits cannot be denied if the conditions of this provision are met. However, the competent authority has significant leeway in determining whether they are met as these conditions are very subjective.⁴⁸⁵

If a taxpayer is not satisfied with the competent authority's determination the taxpayer can seek U.S. judicial review, by the U.S. Federal Tax Court, of the decision. However, the threshold for such a review would be high as a court would have to first find that the competent authority had abused its discretion by acting in an arbitrary and capricious manner.⁴⁸⁶

To qualify under paragraph 6, a taxpayer will be expected to present her case to the competent authority for a determination based on the facts of her situation. However, the taxpayer will not be required to wait until benefits are denied under one of the other provisions of the Article before applying for a competent authority determination. If the competent authority grants relief, it will be provided retroactively to the time the relevant treaty provision entered into force or the time the structure in question was established, whichever is later.⁴⁸⁷ The rationale behind the competent authority provision is that it is intended to be a safety net for Canadian residents engaged in *bona fide* non-treaty shopping activities who are unable to fulfill one of the other tests in the LOB Article. However, as will be discussed below, this provision has several drawbacks and Canadians not engaged in treaty shopping may still be denied treaty benefits they were once entitled to.

⁴⁸⁵ See *supra* note 16 at 981.

⁴⁸⁶ See *supra* note 271 at 24:9 discussing the comments by U.S. Treasury Department Associate International Tax Counsel Carol Dunahoo.

⁴⁸⁷ See *supra* note 113, Third Protocol, Technical Explanation, Article 18.

An example that illustrates the applicability of this provision is the above⁴⁸⁸ multinational derivative benefits example where Canco and its subsidiaries, which were beneficially owned by several multinational corporations, were not qualifying persons nor could they satisfy any of the exceptions to the qualifying person requirement. However, Canco and its subsidiaries may be able to obtain treaty benefits through the use of the competent authority provision. If Canco had been operating under the same or similar structure before January 1, 1996, and the structure reflects the commercial objectives of the group, it would be clear that a principal purpose for the creation and existence of Canco and its subsidiaries was not to obtain treaty benefits.⁴⁸⁹ In the facts of the example, Canco had a legitimate and active business in Canada, it had U.S. source income derived from a similar sector of the economy and its beneficial shareholders are taxpayers resident in countries with which the U.S. has comprehensive tax treaties and which have tax rates which are comparable if not higher than the U.S.⁴⁹⁰ Thus Canco should be granted treaty benefits under paragraph 6 for its U.S. source income.

a) *Problems with Competent Authority Discretion:*

A Canadian resident corporation that is not entitled to treaty benefits because it is not a qualifying person, and which does not come within the active business and derivative benefits exceptions, will have to rely on the last resort of requesting the U.S. competent authority to determine whether its creation or existence did not have the principal purpose of obtaining treaty benefits that would not otherwise be available, or that it would not be appropriate to deny treaty benefits. If one of these two questions is answered in the Canadian resident's favour then the U.S. competent authority must grant treaty benefits. However, this test is not as simple or cost free in application as one may believe it is.

An initial problem is that the criteria of whether one of the principal purposes is to obtain treaty benefits may be troublesome. Goossen states that the "principal purpose" criteria refer not only to the establishment and acquisition of an entity or the conduct of its

⁴⁸⁸ See text accompanying notes 476–479.

⁴⁸⁹ See *supra* note 20 at 53.

⁴⁹⁰ *Ibid.*

operations, but also to its maintenance.⁴⁹¹ An entity which originally was established for *bona fide* business reasons, may, because of changed commercial or other non-tax reasons, no longer have a business purpose for its maintenance. The tax efficiency argument for maintaining the corporate structure of the entity becomes more pronounced and the company will be required to reorganize or it will be considered to be treaty shopping since one of its principal reasons for existing is obtaining treaty benefits.⁴⁹² This will be problematic for tax practitioners because not only must they convince the U.S. competent authority that the principal purpose for the creation and existence of a Canadian resident seeking treaty benefits under this provision is not obtaining treaty benefits, they must also convince the authority that the *maintenance* of the Canadian resident's structure is not motivated by a desire to obtain treaty benefits it otherwise would not be entitled to. This may become a large problem for several Canadian entities when the Protocol comes into effect on January 1, 1996. After this date several Canadian resident entities, which previously were entitled to treaty benefits, will be denied benefits under the Protocol and will have to convince the U.S. competent authority that the maintenance of their current structure is for commercial purposes and not for treaty shopping reasons. For instance in the above⁴⁹³ multinational derivative benefits example Canco will have to convince the IRS that its, and that of its subsidiaries' existence is not motivated by treaty shopping purposes, but has a commercial reason.

The second problem with seeking a competent authority ruling is that it can be a time consuming and expensive process. As O'Brien states, a request to the U.S. competent authority for treaty benefits is not necessarily the method of choice because it is neither quick nor inexpensive.⁴⁹⁴ Other critics have criticized the competent authority system as being lengthy, time consuming and not enough personnel are responsible for

⁴⁹¹ See *supra* note 551 at 24.

⁴⁹² *Ibid.*

⁴⁹³ See text accompanying notes 476-479.

⁴⁹⁴ See *supra* note 20 at 53.

overseeing its maintenance.⁴⁹⁵ Further, the onus is on the Canadian resident to present their case and demonstrate that they are entitled to treaty benefits.

The third drawback to the competent authority ruling system is its subjective nature and lack of specific conditions taxpayers must meet to qualify for treaty benefits creates uncertainty as to the outcome.⁴⁹⁶ For this process to function effectively, the business and investment community must develop confidence that the system is genuinely functional.⁴⁹⁷ This requires publicly identifiable procedures that indicate when treaty benefits will be available.⁴⁹⁸ The LOB Article does not provide any such procedures, it merely includes criteria that are subjective and uncertain in nature that the competent authority should consider.⁴⁹⁹ The Technical Explanation also does not include any publicly identifiable procedures or detailed criteria. It merely states that in making a determination under paragraph 6, the competent authority will take into account all relevant facts and circumstances relating to the person requesting the benefits. In particular, the competent authority will consider the history, structure, ownership, including ultimate beneficial ownership, and operations of the person.

It can be argued that the inherent nature of such a provision requires open ended undefined criteria and a degree of subjectivity in order for the broadest possible application to *bona fide* applicants. However, paragraph XIX of the MOU to the U.S.–Netherlands Tax Treaty contains six specific factors that can be considered by the competent authority in deciding whether treaty benefits should be granted.⁵⁰⁰ Essentially,

⁴⁹⁵ See *supra* note 633 at 254 and note 189.

⁴⁹⁶ See *supra* note 20 at 53.

⁴⁹⁷ See *supra* note 201 at 24.

⁴⁹⁸ *Ibid.*

⁴⁹⁹ They are: (1) whether the creation and existence of the person did not have as a principal purpose obtaining treaty benefits that would not otherwise be available to the person; and (2) whether it would not be appropriate, in view of the purpose of the Article, to deny benefits.

⁵⁰⁰ These factors are: (1) The date of incorporation of the corporation in relation to the date that this Convention entered into force; (2) The continuity of the historical business and ownership of the corporation; (3) The business reason for the corporation residence in its State of residence; (4) The extent to which the corporation is claiming special tax benefits in its country of residence; (5) The extent to which the corporation's business activity in the other state is dependent on the capital, assets, or personnel of the corporation in its State of residence; (6) The extent to which the corporation would be entitled to treaty benefits comparable to those afforded by this

these factors compromise a summary of the LOB concept as they describe situations that qualify as *bona fide* transactions entitled to treaty benefits.⁵⁰¹ The MOU to the U.S.–German Tax Treaty also provides a list of factors that will be taken into consideration by the competent authority.⁵⁰² The Technical Explanation to the Protocol unfortunately does not contain a similar list of factors to guide taxpayers in determining whether they would be entitled to treaty benefits under this provision.

Nonetheless, the lack of certainty and the problem of the subjective nature of the competent authority discretion has been partially solved by the IRS. The IRS has established a new revenue procedure that sets forth rules on how taxpayers can request U.S. competent authority assistance under the provisions in U.S. tax treaties.⁵⁰³ These procedures must be used followed unless a treaty provides specific procedures.⁵⁰⁴ However, where a treaty provides that the competent authority may as a matter of discretion determine the availability of treaty benefits when the prescribed requirements in a LOB provision are not met, as in the Protocol, the request for competent authority should comply with Revenue Procedure 96–13.

C. General Anti–Abuse Provision:

Paragraph 7 clarifies that U.S. and Canadian general anti–abuse provisions apply in addition to the provisions in the LOB Article. The fact that the provisions in paragraphs 1 through 6 are applicable only by the United States does not restrict the right of Canada or the U.S. to deny treaty benefits where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Treaty.⁵⁰⁵ Paragraph 7 was added at

Convention if it had been incorporated in the country of residence of the majority of its shareholders. *See supra* note 323 at 24.

⁵⁰¹ *Ibid.*

⁵⁰² These factors include: (1) the existence of a clear business purpose for the structure and location of the income earning entity; (2) the conduct of an active trade or business by the entity, instead of investment activity; and (3) a valid nexus between the entity and the activity giving rise to the income.

⁵⁰³ Revenue Procedure 96–13, 1996–3 I.R.B. 1.

⁵⁰⁴ *Ibid.* section 2.02.

⁵⁰⁵ This principal is recognized by the OECD in the Commentaries to its Model Tax Treaty on Income and on Capital. The United States and Canada agree that this principle is inherent in the Treaty.

Canada's request to confirm that, although these provisions apply only for the purposes of the application of the Treaty by the United States, this should not be construed so as to limit the right of each Contracting State to invoke applicable anti-abuse rules.⁵⁰⁶ The Technical Explanation states that Canada will remain free to invoke its applicable anti-avoidance rules to counter abusive arrangements involving treaty-shopping through the United States, and the United States will remain free to apply its substance-over-form and anti-conduit rules in relation to Canadian residents.⁵⁰⁷ The Protocol does not limit the anti-abuse rules which Canada and the U.S. can apply under paragraph 7. Thus in order to determine which rules apply an examination of Canadian anti-avoidance and U.S. substance-over-form and anti-conduit rules is necessary. As this thesis involves an examination of the application of the LOB rules by the U.S. to Canadian residents, my discussion of applicable Canadian and U.S. anti-abuse rules will focus upon the U.S. provisions.

i. Substance-Over-Form and Anti-Conduit Rules:

Under the substance-over-form concept, U.S. courts have stated that the incidence of taxation depends upon the substance of a transaction as a whole and not necessarily on its form.⁵⁰⁸ This doctrine prevents the true nature of a transaction being disguised by mere formalisms, which exist solely to alter a taxpayer's tax liabilities. In certain cases, courts have recharacterized transactions in order to impose tax consistent with this principle. For example, where three parties have engaged in a chain of transactions, the courts have at times ignored the "middle" party as a mere "conduit," and imposed tax as if a single transaction had been carried out between the parties at the ends

⁵⁰⁶ Boidman has stated that it is amusing and not totally comprehensible that the Joint Committee on Taxation of the U.S. Senate expressed a concern that U.S. taxpayers could be unduly prejudiced by the regime under Article XXIX A because the *detailed* rules that limit treaty benefits for Canadians could somehow serve to preclude the U.S. from applying its residual anti-avoidance rules, although nothing in paragraph 7 would so indicate. While U.S. taxpayers would not be subject to specific rules but rather to the *terrorizing* effects of *uncertain* and *amorphous* Canadian general anti-avoidance rules. See *supra* note 13.

⁵⁰⁷ See *supra* note 113, Technical Explanation; Article 18(7). Neither, the Protocol, nor its Technical Explanation, discuss which *applicable* anti-abuse rules Canada will apply and neither mentions which particular substance-over-form and anti-conduit rules the U.S. will apply. The negotiators most likely did not specify which anti-abuse rules apply so as not to limit the ability of Canada and the U.S. to counter abusive transactions through their domestic tax laws, which as we know change frequently from time to time.

⁵⁰⁸ See, e.g., *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

of the chain. In *Aiken Industries, Inc. v. Commissioner*,⁵⁰⁹ one of seminal U.S. cases on treaty shopping, the U.S. Tax Court recharacterized an interest payment by a U.S. person on its note held by a related treaty-country resident, which in turn had a precisely matching obligation to a related non-treaty-country resident, as a payment directly by the U.S. person to the non-treaty-country resident. The transaction in its recharacterized form resulted in a loss of the treaty benefits that would otherwise have applied on the payment of interest by the U.S. person to the treaty-country resident, and thus caused the interest payment to give rise to the 30 percent U.S. withholding tax.

The IRS has taken an analogous position in applying the substance-over-form concept where an unrelated financial intermediary is interposed between the two related parties, as a lender to one and borrower from the other, if the intermediary would not have made or maintained the loan on the same terms without the corresponding borrowing.⁵¹⁰ Similarly, in a technical advice memorandum, the IRS determined that interest payments by a U.S. company to a related, treaty protected financial intermediary may be treated as payments by the U.S. company directly to the foreign parent of the financial intermediary even though the matching payments from the intermediary to the parent are not interest payments, but are dividends.⁵¹¹

Under the conduit approach the IRS argues that while the intermediary is a valid corporation it merely serves as a conduit for passing interest, dividend and royalty payments to the parent at reduced rates. The effect under this approach is that the withholding rate will be increased to the amount that the parent would pay if it received the income directly.⁵¹² One of the significant anti-conduit rules is section 7701(1) of the IRC, enacted in 1993, which expressly authorizes the Treasury Secretary to promulgate regulations that set forth rules for recharacterizing any multiple-party financing transaction as a transaction directly among any two or more of such parties, where the

⁵⁰⁹ 56 T.C. 925 (1971).

⁵¹⁰ Rev. Rul. 87-89, 1987-2 C.B. 195.

⁵¹¹ Tech. Adv. Mem. 9133004 (May 3, 1991).

⁵¹² See *supra* note 42 at 290.

Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by the IRC. The U.S. recently released regulations on conduit financing arrangements under IRC section 7701(1) that are designed to supplement LOB provisions in U.S. tax treaties.⁵¹³ These regulations do not overlap with LOB provision as they test transactions while LOB provisions test the qualification of an entity as a resident. Thus, an entity that satisfies the LOB rules may still serve as a conduit for the benefit of third country residents and will fall within the ambit of these regulations. These regulations permit the IRS to disregard the existence of an intermediary/conduit financing entity for the purposes of withholding tax provisions where the participation of the intermediary is found to be part of a plan to avoid tax. Additionally, the regulations impose significant reporting obligations on U.S. persons that obtain borrowings as part of a financing arrangement. If the intermediate entity is related to the financing entity or the financed entity, the financing arrangement generally will be subject to recharacterization if: (1) the participation of the intermediate entity in the financing arrangement reduces U.S. withholding tax; and (2) the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan. If the intermediate entity is unrelated to both the financing entity and the financed entity, the financing arrangement generally will be subject to recharacterization if the two conditions described above are satisfied and, in addition, the intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity. In summary, these regulations apply if there is: (1) a financing arrangement; (2) the reduction of taxes imposed at source on interest, lease or royalty payments; and (3) a tax avoidance plan.⁵¹⁴ Hence, anytime there is a financing arrangement these regulations will have to be considered in addition to the provisions in the LOB Article. While the LOB Article may grant treaty benefits to certain entities the conduit regulations may deny them.

⁵¹³ See Reg. Section 1.881-3 *et seq.*

⁵¹⁴ *Ibid.* and *see supra* note 271 at 24:15-24:17.

ii. *Canadian Anti-Avoidance Rules:*

The primary Canadian anti-avoidance rule which U.S. residents will face is the General Anti-Avoidance Rule ("GAAR"), enacted in 1988.⁵¹⁵ This rule provides that where a transaction is an "avoidance transaction" the tax consequences shall be determined as is reasonable under the circumstances in order to deny a tax benefit that would otherwise result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.⁵¹⁶ An "avoidance transaction" is a transaction other than one that may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain a tax benefit. However, tax benefits will not to be denied where it may reasonably be considered that the transaction would not result, directly or indirectly, in a misuse of the provisions of the ITA or an abuse having regard to the provisions of that Act, read as a whole.

In addition to GAAR, U.S. residents would be well advised to review the Supreme Court of Canada recent case, *The Queen v. Crown Forest Industries Limited*, where the Court condemned treaty shopping as an abuse of the residence provision in the Convention.⁵¹⁷

⁵¹⁵ As I already mentioned, I shall not go into any great detail concerning the applicable Canadian anti-abuse rules as my thesis is intended to address the consequences of the LOB Article on Canadian residents, not U.S. residents. While GAAR is the primary Canadian anti-abuse weapon that potential U.S. resident treaty shoppers will face, Ward reports that Department of Finance officials have indicated that if Canadian courts are not prepared to recognize the validity of applying anti-abuse rules, whether GAAR or some other judicially developed rule, they would be prepared to propose an amendment to the *Income Tax Conventions Interpretation Act* to provide a specific rule for these purposes. David Ward, Q.C., *Ward's Tax Treaties 1994-1995* at 66 (Thomson: Scarborough, 1994).

⁵¹⁶ ITA section 245 *et seq.*

⁵¹⁷ 95 DTC 5389. In *Crown Forest* the Canadian corporate taxpayer rented barges to Norsk, a non-resident corporation incorporated in the Bahamas. The corporate taxpayer withheld Canadian tax at a rate of 10 percent. The taxpayer claimed that Norsk was a resident of the U.S., because its mind and management was located there, and thus under Article XIII.2 of the Convention was entitled to the 10 percent rate. Revenue Canada stated that Norsk was a resident of the Bahamas and thus pursuant to ITA section 212(1)(d) the rate of withholding should have been 25 percent since the Bahamas, a tax haven, does not have a tax treaty with Canada. The Supreme Court of Canada held that Norsk was not a resident of the U.S. and thus was not entitled to the reduced withholding rate under the Convention. The Court reasoned that, although Norsk was carrying on a trade or business that was effectively connected with the U.S., the benefits of the Convention were intended only for persons who were resident in one of the contracting states. Those persons are considered residents if they are liable to tax in one of the contracting states on their world-wide income, not merely their source income.

Further, U.S. residents would be well advised to review the other Canadian anti-abuse doctrines, such as the sham doctrine, the substance over form doctrine, and the legally effective transaction doctrine. However, there is a

iii. *Problems with the General Anti-Abuse Provision:*

One of the problems with the problems with general anti-treaty provision in paragraph 7 is that, while the U.S. is able to apply the complex anti-treaty shopping rules in paragraphs 1 through 6, it is not entirely clear whether Canada can apply GAAR. A tax treaty is an agreement between two countries and if the treaty permits a country to deny benefits that by itself should be sufficient grounds for denial.⁵¹⁸ Russell speculates that paragraph 7 can be viewed as an anti-avoidance provision that authorizes Canada to deny benefits. The alternative view is that Canada must still rely on GAAR to deny treaty benefits. Russell states that if this is the case it is uncertain whether Canada would be able to apply GAAR to a tax treaty without amending the *Income Tax Conventions Interpretation Act*, since GAAR is not specifically referred to in that Act.⁵¹⁹ Even if this amendment was made Russell concludes that general principles of treaty interpretation may prevent the application of GAAR. I would favour the application of the former interpretation, that paragraph 7 is a general anti-abuse provision in itself and allows Canada to deny treaty benefits to U.S. residents without necessarily applying GAAR. The intent of the negotiators was to provide Canada with the ability to deny treaty benefits where to do otherwise would be an abuse. An interpretation that limits Canada's ability to deny benefits by requiring the application of GAAR would be not be in line with this intent. Further, the inability of Canada to apply GAAR would be inequitable and non-reciprocal as the U.S. would have the power to deny treaty benefits under both the LOB provision and its domestic general anti-abuse provisions, while Canada could do neither.

The second problem identified with paragraph 7, although not something I necessarily consider a significant problem, was noted by the Joint Committee on Taxation ("JCT"). The JCT noted that U.S. residents will find the portion of this provision allowing Canada to apply its general anti-abuse rules objectionable because of its opacity,

debate as to whether Canada can apply these doctrines, or whether the Protocol limits it to GAAR. See *infra* discussion in text following note 518.

⁵¹⁸ See *supra* note 16 at 982.

⁵¹⁹ *Ibid.*

one-sidedness, and lack of conformity to other tax treaties.⁵²⁰ The JCT argued that paragraph 7 could be considered opaque and, therefore as not providing taxpayers with adequate guidance or certainty, because it relies only on domestic Canadian tax law to determine whether a U.S. resident is not entitled to treaty benefits in Canada due to an abuse of the Convention's provisions. The JCT found this objectionable as legislative or judicial developments could change the substance of Canadian tax law with respect to what constitutes such an abuse and/or Canadian law might be interpreted more strictly in the future than at present, precluding presently qualifying U.S. residents from treaty benefits. As a result, relying exclusively on domestic Canadian tax law to prevent treaty shopping through the United States may create uncertainty from one year to the next for U.S. residents that would otherwise be eligible for treaty benefits.

While the U.S. may find the lack of specifically enumerated criteria, such as those in an LOB provision which U.S. residents must fulfill in order to receive treaty benefits objectionable, I do not. First, the majority of bilateral tax treaties, other than U.S. tax treaties, include a provision similar to paragraph 7, which allows a nation to apply its domestic anti-abuse tax laws to prevent treaty abuse. Second, as the JCT itself recognized, the same type of uncertainty could arise for residents of Canada as a result of legislative or judicial changes in what constitutes treaty abuse under U.S. domestic tax law.⁵²¹ Consequently, Americans are not in a worse position than Canadians in terms of the potential changes to domestic anti-abuse provisions. In fact they are in the same position as Canadians as both the U.S. and Canada could unilaterally amend these provisions and/or interpret them more strictly so as to deny treaty benefits. Further, according to past experience, it is Canadians who will be at a disadvantage in terms of U.S. domestic laws aimed at curbing treaty abuse. It was the U.S. that, over the adamant objections of its treaty partners, passed the branch profits tax rules in 1986 that unilaterally

⁵²⁰ Congressional Joint Committee on Taxation, *Explanation to the Protocol to the U.S.-Canada Income Tax Treaty*, 95 TNU 101-14 (May 25, 1995). The Joint Committee on Taxation is a technical advisory group to the U.S. Congress. Congress is charged with oversight of tax treaties, it oversees the Treasury Department's activities and gives advice and consent to the Treasury to take action on treaties. The Joint Committee does the technical background work required to assist Congress in this role.

⁵²¹ *Ibid.* at footnote 46.

overrode several of its tax treaties. Further, Canadians, and not Americans, will also be at a disadvantage as a result of the Protocol because not only are they subject to the rigorous provisions in the LOB Article, but they must also contend with U.S. domestic substance-over-form and anti-conduit tax laws. Even the JCT acknowledged that while the anti-abuse rule in paragraph 7 is intended to be reciprocal, unlike the rest of the LOB provisions in the Protocol, because the LOB Article's detailed tests that apply only in the case of Canadian residents, and the fact that U.S. internal-law anti-abuse rules may reach more broadly than Canada's, the LOB Article on a whole may be one-sided.⁵²²

Impact on Canadian Residents of the Denial of Treaty Benefits:

The immediate impact of the denial of treaty benefits will be the imposition by the U.S. of its maximum withholding tax of 30 percent on gross U.S. source income. However, as a result of Canada's foreign tax credit mechanism that provides a credit or deduction for foreign taxes paid the denial of treaty benefits may not result in an actual increase in the total tax burden. Nonetheless, there will be situations where the actual tax burden will have increased because of higher overall taxation or because foreign tax credits or deductions cannot be utilized. Additionally, Canadian residents may experience cash flow difficulties if they are required to pay the maximum U.S. withholding tax and then wait for a foreign tax credit for their Canadian taxes. Therefore, the incidents of double taxation that the Convention is intended to prevent may actually increase as a result of the LOB Article in the Protocol.

A brief overview of the foreign tax credit system is necessary to fully understand how the LOB Article may result in an increase in Canadian residents' overall tax burden. The Canadian foreign tax credit provisions, in section 126 of the ITA, are designed to reduce the effect of double taxation on the foreign source income of Canadian resident taxpayers.⁵²³ Section 126 provides a unilateral direct tax credit for the majority of foreign

⁵²² *Ibid.*

⁵²³ See *supra* note 26 at 134.

The basic foreign tax credit formula for foreign non-business income or business income is:

taxes paid. The foreign tax credit system is not based on any tax treaty, but applies unilaterally to Canadian residents who have paid foreign taxes. Basically, section 126 provides a direct deduction of foreign taxes paid from Canadian income tax otherwise payable on that foreign income. Alternatively, a deduction from income may be allowed under subsections 20(11) & (12). If the foreign tax is a proper charge against profit, and does not fall within the statutory restrictions of section 18(1)(a), such as payments on account of capital, the foreign tax is deductible. This becomes significant since many levies imposed by foreign nations are not considered foreign taxes for the purposes of the foreign tax credit system in section 126,⁵²⁴ but they may be deductible as expenses incurred for the purposes of gaining or producing income.⁵²⁵ Nonetheless, a tax that is specifically identified as being subject to the provisions of a comprehensive income tax treaty between Canada and another country automatically qualifies as an income or profits tax.⁵²⁶ All the U.S. taxes enumerated in the Convention and Protocol are considered foreign taxes for the purposes of the foreign tax credit and are creditable as such.⁵²⁷

Canadian taxpayers may encounter problems as a result of the foreign tax credit system because the Canadian system, unlike the U.S. approach, calculates and applies foreign tax credits on a country by country basis. A foreign tax credit is only allowed against income earned in the particular country where the Canadian resident taxpayer paid taxes. Further, a taxpayer's claim for a foreign tax credit on business income tax cannot exceed the Canadian tax otherwise payable on that income.⁵²⁸ If the taxes are greater than

The foreign tax credit will be the lesser of a) the foreign taxes paid in respect of the income source; or b) the amount determined by the formula:

$$(\text{Foreign source income} / \text{World-wide income}) \times \text{Canadian taxes payable on world-wide income.}$$

⁵²⁴ For example: resource royalties, voluntary contributions to governmental authorities, and payments to acquire rights or privileges. Interpretation Bulletin IT-270R2 Foreign Tax Credit, para. 6 (Feb. 11, 1991).

⁵²⁵ See *supra* note 523 at 135.

⁵²⁶ See *supra* note 524, IT 270R2 para. 8.

⁵²⁷ Article II of the Convention was amended by the Protocol to increase the number of taxes covered. The Convention now applies to all taxes imposed by the Government of Canada under the ITA and all taxes imposed by the United States Government. The Protocol also clarifies that the Convention applies to all future identical or substantially similar taxes.

⁵²⁸ See *supra* note 524, IT-270R2 para. 5

the net income earned the applicable foreign tax credit cannot be used against taxes paid in another jurisdiction. Further, credits are segregated into foreign tax credits applying to foreign non-business income and foreign business income.⁵²⁹ This approach creates problems for Canadians operating in foreign jurisdictions with a higher tax rate than Canada or where the Canadian taxpayer is operating at a loss. The Canadian resident may not be able to utilize the entire foreign tax paid as a foreign tax credit as the foreign tax credit system only provides a credit against applicable Canadian taxes. If the foreign tax rate is higher and/or the applicable Canadian tax is eliminated through the use of the foreign tax credit then any excess foreign tax credit that cannot be utilized in that year must be carried forward to be used against future taxes imposed by that jurisdiction.⁵³⁰ The excess foreign tax credit cannot be used as a credit against taxes from another jurisdiction. Additionally, the foreign income must be subject to Canadian taxation. If the foreign income is not subject to taxation in Canada then there will be no foreign tax credit allowable for any taxes paid on the foreign income. However, the taxpayer may deduct as an expense excess foreign tax credits and foreign taxes on business income that are not subject to taxation in Canada.⁵³¹ However, a consequence of the deduction of foreign tax credits as a business expense is that the balance of the taxes otherwise payable may not be sufficient to enable the taxpayer to fully utilize other deductions. Thus, a taxpayer should not claim the entire foreign tax credit as a business expense, but carry it forward to another year in the hope that it can be utilized against future foreign taxes.

⁵²⁹ See *supra* note 523 at 135. Under section 126(1) any taxpayer can deduct non-business income tax paid to a foreign government but only so far as to reduce the total taxes paid to that country. Under section 126(2) any taxpayer who carried on business in a foreign country can deduct business income tax paid to the foreign government, once past foreign tax credits are used and any non-business income foreign tax credits under section 126(1) have been used.

⁵³⁰ The foreign tax expenditure can be carried forward 7 years or back 3 years. Since the Canadian foreign tax credit system operates on a country-by-country basis, foreign tax credits related to a particular jurisdiction can only as credits against future or past taxes of that jurisdiction. There is no carry forward allowed for the unused foreign tax credit on non-business income, however it can be deducted in the current year.

⁵³¹ New section 110.5 may provide relief for excess foreign tax credits as it allows the foreign tax credit to be used immediately instead of carrying them forward as future tax credits or utilized as business deductions. This section allows the notional adding of income to prevent the loss of the foreign tax credit where the Canadian resident has no Canadian tax otherwise payable. The foreign tax credit is carried forward as a non-capital loss. A Canadian resident can elect to notionally increase its income to an amount necessary to use the foreign tax credit, and then add the same amount to its non-capital losses available for carrying forward to subsequent profitable years. However, the notional adding of income results in higher Canadian tax that is immediately payable.

As mentioned, Canadian resident taxpayers may experience a significant detriment as a result of failing to obtain treaty benefits under the Protocol and not being able to make use of the higher withholding taxes as foreign tax credit against applicable Canadian taxes. For example, a Canadian resident corporation with a U.S. branch operation that was entitled to treaty benefits prior to the Protocol but that is now a non-qualifying person and does not meet the active business or derivative benefits tests will face a higher total tax bill. Before the Protocol came into effect on January 1, 1996, the Canadian resident was subject to U.S. income tax of approximately 40 percent on its branch's income and a 10 percent withholding on the remainder, for a total of tax bill of 46 percent. Presently, the U.S. branch operation will pay the same U.S. income tax of approximately 40 percent, but since the Canadian resident is not entitled to treaty benefits under the Protocol, the U.S. withholding tax will be 30 percent of the remainder, for a total of 58 percent.⁵³² The Canadian resident will be entitled to a foreign tax credit only to the extent of the Canadian tax otherwise payable on the U.S. source income, approximately 45 percent. Since, the total U.S. taxes are greater than the applicable Canadian taxes a foreign tax credit will not be available for the excess unless the Canadian resident has other U.S. source income to apply the foreign tax credit against. If the Canadian resident does not have other U.S. source income, then it must carry forward the foreign tax credit to use against future U.S. source income or it can attempt to use the foreign tax credit as a business expense. If the Canadian resident cannot carry forward the foreign tax credit for use it as a deduction then its overall tax burden for its U.S. source income will have increased by 12 percent as a result of the LOB Article.

A second example where a Canadian resident will face higher taxation as a result of not fulfilling the requirements of the LOB Article would be where a Canadian resident with a U.S. subsidiary fails the active business test because the subsidiary's active business income is not considered in connection with or incidental to the Canadian activities.⁵³³ The dividends paid by the U.S. subsidiary out of active business income to the Canadian

⁵³² This example is adapted from O'Brien's Article, *supra* note 20 at 54. On \$100 of branch profits, \$40 will be paid as U.S. income tax leaving \$60. On this \$60, \$18 will be withheld. The total tax bill will \$58, or 58 percent.

⁵³³ This example is adapted from O'Brien's Article, *ibid.*

parent will not be taxable in Canada because they are treated as non-taxable exempt surplus. However, these dividends are also not eligible for a foreign tax credit. If the U.S. subsidiary earns \$100 active business income it will pay approximately 40 percent U.S. tax on this income. If the subsidiary then pays the remainder of this income as a dividend to its Canadian parent, the dividend will be subject to a withholding tax in the U.S. of 30 percent, instead of the Protocol's rate of 5 percent⁵³⁴ or the previous rate of 10 percent under the Convention. Thus the total tax burden of the parent and subsidiary on the income of the U.S. subsidiary will be 58 percent, instead of 43 percent if treaty benefits under the Protocol were available, or 46 percent before the Protocol came into effect.

The denial of treaty benefits to a Canadian parent on income it receives from its U.S. branch or subsidiary can exacerbate cash flow difficulties and may place the Canadian parent in a loss position.⁵³⁵ Unless, the Canadian parent has Canadian tax payable on U.S. source income, it will not be able to use its foreign tax credit. The Canadian parent will have to carry forward the foreign tax credit in hopes of using it against future U.S. source income that is taxable in Canada. Alternatively, the Canadian parent can elect to increase its income to the amount necessary to use the credit and then add that income to its non-capital losses available for carry forward to subsequent profitable years.⁵³⁶ Eventually the U.S. withholding tax will be offset by deducting the additional losses against future profits to reduce Canadian tax. However, the taxes withheld in the loss year will be a cash outlay in a year the corporation may be short of funds. Further, the increase in federal income to utilize the credit will result in additional provincial corporate taxes.⁵³⁷ Hence, while, in theory, the foreign tax credit system should alleviate the burden of increased U.S. withholding taxes, in practice Canadian residents may still face a higher overall tax bill, or at least cash flow difficulties, if they are unfortunate enough to not qualify under the LOB Article.

⁵³⁴ The rate will be 6 percent in 1996 and reduced to 5 percent in 1997.

⁵³⁵ See *supra* note 20 at 54.

⁵³⁶ *Ibid.*

⁵³⁷ *Ibid.*

Impact of the Limitation on Benefits Article on Canadian Tax Revenue:

The other unintentional, or possibly intentional, result of treaty benefits being denied because Canadian residents do not meet the requirements of the LOB Article, is that the allocation of jurisdiction to tax on the basis of residency becomes effectively reversed.⁵³⁸ The interaction of the LOB Article and Canada's foreign tax credit system will cause tax revenues, that would have flowed to the Canadian government, to be diverted to the American treasury.⁵³⁹ While it is against the policy of the U.S. Treasury Department to release figures on the impact tax treaties on tax revenues, the U.S. Senate Foreign Relations Committee reports that they have 'been informed by the staff of the Joint Committee on Taxation that the Protocol is estimated to increase Federal budget receipts by less than \$ 50 million annually during the fiscal year 1995–2000 period.'⁵⁴⁰ However, I would argue that these figures are debatable and seem artificially low. First, accurate estimates of a treaty's revenue impact are difficult to gauge. The Treasury Department does not publish revenue estimates concerning tax treaties and it is difficult to determine which provisions raise revenue and which ones lose revenue.⁵⁴¹ Second, Jenkins et al, report that raising the Canadian withholding tax from 15 percent to 25 percent on U.S. investments in Canada would have resulted in an increase in Canadian tax revenues of \$180 million in 1972 and \$193 million in 1974.⁵⁴² It is hard to believe that the impact of the LOB provision which will increase the withholding tax on non-qualifying persons from 5 percent–15 percent to 30 percent will only result in a an increase of \$50 million in tax revenues in 1996, particularly when the increase in cross-border trade and investment that has occurred after the passage of twenty years is considered. Third, the \$50 million annual figure the JCT estimated, in my opinion, is probably on the low end of

⁵³⁸ *Ibid.* at 53.

⁵³⁹ *Ibid.*

⁵⁴⁰ *See supra* note 91.

⁵⁴¹ *See supra* note 418 at 481.

⁵⁴² *See supra* note 197 at 153. I have used these examples of increasing Canadian tax revenues, as a result of increasing Canada's withholding tax, as I have not come across any studies discussing the impact of increasing the U.S. withholding tax on the US tax revenues.

the scale as U.S. negotiators would be wary of publishing figures on the high end of the scale for fear of dissuading Canada from agreeing to the LOB in the Protocol.

The bulk of increased tax revenues will of course be through the application of the maximum U.S. withholding rate to non-qualifying Canadian residents. This will impact Canadian tax revenues as the higher withholding taxes the U.S. government will receive will be funded through greater Canadian foreign tax credits used to offset Canadian tax liabilities. Not only will Canadian tax revenues be reduced through the interaction of the LOB Article and the Canadian foreign tax credit system, but the general reduction of withholding taxes under the Protocol will also cause the Canadian government to lose significant tax revenues.⁵⁴³

⁵⁴³ See text following note 100.

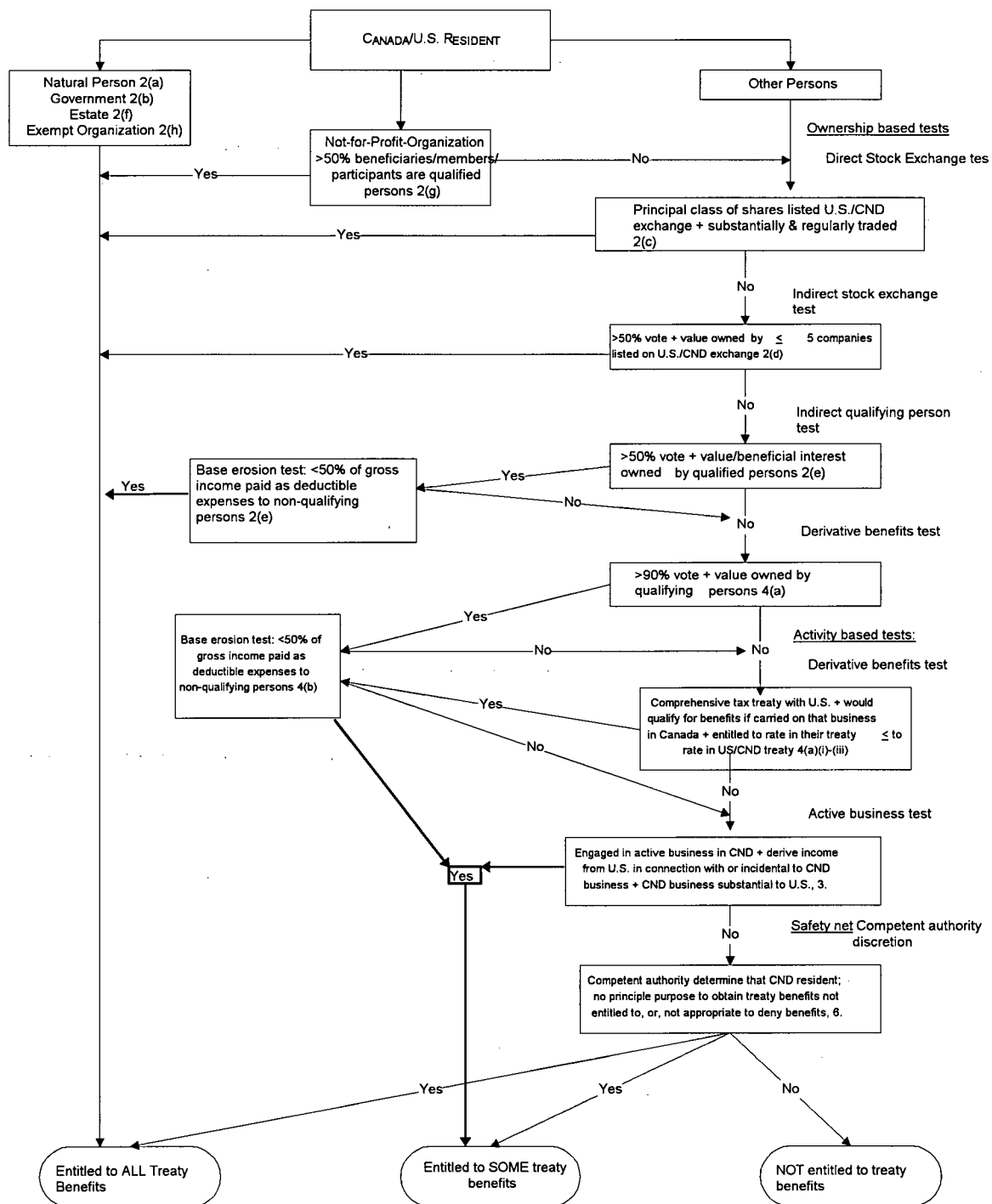


Figure 8: Limitation on Benefits Flow Chart.⁵⁴⁴

⁵⁴⁴ This flowchart is based on Goossen's chart concerning the LOB article in the U.S.–Netherlands Treaty, *infra* note 323 at 38–40. It should be noted that the LOB article in the U.S.–Netherlands Treaty also has a headquarters test, and a shipping/aircraft income test, as additional active income tests. These are not found in the Protocol.

ALTERNATIVES AND FUTURE AMENDMENTS TO THE LIMITATION ON BENEFITS PROVISION:

In this chapter, I shall discuss alternatives to the LOB Article by examining analogous provisions in the OECD and U.N. Model Conventions. Using these analogous provisions, I shall then suggest proposals to amend the LOB Article and rectify some of the potential problems I have identified.

Alternatives:

The treatment of treaty shopping varies from country to country due to the differing attitudes of governments and courts.⁵⁴⁵ While countries such as the U.S. have expressed great concern over treaty shopping, others have not. For example, U.K. tax authorities have a more relaxed approach to treaty shopping than U.S. authorities. While the U.K. has recently negotiated tax treaties with several eastern European countries, none of these treaties have included extensive anti-abuse rules.⁵⁴⁶ The relaxed view of LOB provisions prevails in other common law jurisdictions including Australia, Canada, India, Ireland and New Zealand.⁵⁴⁷ International authorities have not reached a consensus as to whether the tax avoidance that results from treaty shopping should be curtailed and by what means.⁵⁴⁸ For example the U.N. Ad Hoc Group of Experts on Tax Treaties Between Developed and Developing Countries ("UN Ad Hoc Group") did not reach an unanimous position. Some countries expressed great concern over treaty shopping while others urged the need for caution and emphasized the necessity to avoid damaging the legitimate activities which tax treaties are designed to encourage.⁵⁴⁹

⁵⁴⁵ See *supra* note 1 at 562.

⁵⁴⁶ See *supra* note 13.

⁵⁴⁷ *Ibid.*

⁵⁴⁸ See *supra* note 1 at 562.

⁵⁴⁹ *Ibid.* at 570.

A. OECD Model Convention and the U.N. Model Convention:

In 1956, the OECD established the Fiscal Committee to examine the possibility of a uniform multilateral tax treaty. This process, and the Model Conventions that resulted from it, influenced several hundred bilateral income tax treaties throughout the world.⁵⁵⁰ Further, the OECD Model Convention is an important interpretive tool in deciding the extent to which treaty benefits will be granted. Both U.S. and Canadian courts have recognized the importance of the OECD Model Convention in this respect.⁵⁵¹

The commentary to Article 1 of the OECD Model Convention states that the purpose of tax treaties is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons, and secondarily that tax treaties should not help tax avoidance or evasion.⁵⁵² Regardless of the policy that tax treaties should not aid tax avoidance and evasion, the OECD Model Convention does not contain anti-abuse provisions. However, the commentary discusses the types of provisions that treaty negotiators might wish to consider and internal law measures that provide possible ways to deal with tax treaty abuse, such as the substance-over-form concept.⁵⁵³ The commentary states that it is the view of the wide majority of OECD member countries that such rules, and their underlying principles, do not have to be confirmed in the text of treaties to be applicable.

The LOB provision in the Protocol is not based on a similar provision in the 1992 OECD Model Convention. The OECD Model does not contain a comparable provision.⁵⁵⁴ This is because tax treaties do not normally concern themselves with the domestic laws that lay down the conditions a person must fulfill in order to be a resident and liable to tax.⁵⁵⁵ Contracting states themselves, in their domestic tax law, establish

⁵⁵⁰ See *supra* note 204 at 792.

⁵⁵¹ See *supra* note 323 at 19.

⁵⁵² Organization for Economic Co-operation and Development, *Model Tax Convention on Income and Capital*, (Paris; OECD 1992).

⁵⁵³ *Ibid.*

⁵⁵⁴ See *supra* note 16 at 966.

⁵⁵⁵ See *supra* note 201 at 13 note 38.

these conditions. Further, the majority of OECD member states do not share the U.S. fixation with treaty shopping and LOB provisions. Opponents of LOB provisions argue that the most offensive treaty shopping situations can be dealt with by existing devices such as *fraus legis*,⁵⁵⁶ substance-over-form and the beneficial ownership test.⁵⁵⁷ Further, less serious instances of treaty shopping are not worth significant concern.

Although, the U.N. and the OECD Model Conventions do not share the same focus as the U.S. on the issue of treaty shopping, or include LOB provisions, they do employ two types of anti-treaty shopping mechanisms: the beneficial ownership test and the limitation on residence status test.⁵⁵⁸ The beneficial ownership test denies treaty benefits to entities that are not the beneficial owners of a particular item of income. Under articles 10, 11 and 12 of the OECD Model Convention, reduced withholding rates for dividends, interest and royalties are available only if the recipient is resident in one of the contracting states and is the beneficial owner of the income.⁵⁵⁹ If a resident of a third country establishes a company in one of the contracting states that merely acts as a nominee or agent in order to obtain treaty benefits, the OECD Convention will deny the reduced withholding rates.⁵⁶⁰ However, the state attempting to deny treaty benefits has the burden of establishing that the company is merely acting as a nominee or agent, which may be difficult and also time and resource consuming. Through this mechanism conduit companies that are established to obtain treaty benefits through treaty shopping would be unable to do so because they would not be the beneficial owner of the income. Similarly, the U.N. Model Convention denies treaty benefits on dividends, interest and royalties to companies that are not the beneficial owner of an item of income.⁵⁶¹ Under these

⁵⁵⁶ Fraud upon law. Black's Law Dictionary 663 (6th Ed. 1990).

⁵⁵⁷ See *supra* note 204 at 292 note 93.

⁵⁵⁸ See *supra* note 1 at 570.

⁵⁵⁹ To determine who the beneficial owner is the OECD suggests examining the following factors: (1) the identity of the shareholders of the intermediary country; (2) the intermediary's relationship to the shareholders or other interested parties; and (3) the decision-making process of the intermediary. See *supra* note 1 at 571.

⁵⁶⁰ See *supra* note 16 at 966.

⁵⁶¹ U.N. Dep't of Int'l Economic and Social Affairs, United Nations Model Double Taxation Convention Between Developed and Developing Countries, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 (1980), see Articles 10-12.

provisions a conduit company is not the beneficial owner when its powers over the income producing assets are so narrow as to render it a mere fiduciary or an administrator acting on account of an interested party.⁵⁶² Thus nominees, agents, and intermediary companies can be denied treaty benefits when they are acting as mere conduits.

The second mechanism incorporated into the OECD and U.N. Model Conventions for preventing treaty shopping is the limitation on residence status test. These Conventions include a provision that excludes from the definition of the term "resident of a contracting state" any person who is "liable to tax in a contracting state in respect only of income from sources in that state or capital situated therein."⁵⁶³ This provision is designed to prevent diplomats from escaping tax liabilities. Diplomats are resident in their host country, but are not subject to tax in that country. Without this provision they could claim the benefits of a tax treaty even though they do not pay any taxes.⁵⁶⁴ However, this provision may also be used to deny treaty benefits to foreign held companies that are exempt from taxation in their state of residence by special tax incentives designed to attract foreign investment on the grounds that it was not a resident of the treaty partner country since it did not fall within the definition of resident.⁵⁶⁵

In addition to the two basic anti-treaty shopping mechanisms, the U.N. Ad Hoc Group and the OECD Fiscal Committee have suggested four other methods to combat treaty shopping.⁵⁶⁶ The first method, the direct or look-through method, allows treaty benefits to flow to a company in the other contracting state only if its shares are held by residents of that state.⁵⁶⁷ Under the look-through approach, tax authorities must pierce the corporate veil and determine whether the shareholders/beneficiaries would be entitled

⁵⁶² See *supra* note 1 at 571.

⁵⁶³ See OECD Model Convention *supra* note 552, Article 10 and *supra* note 1 at 572.

⁵⁶⁴ *Ibid.*

⁵⁶⁵ *Ibid.* at 572-73.

⁵⁶⁶ See *supra* note 1 at 573 discussing U.N. Study and OECD Committee on Fiscal Affairs, Tax Evasion, Tax Avoidance and Tax Planning, International Tax Avoidance and Evasion 88.

⁵⁶⁷ See *supra* note 1 at 574. These anti-treaty shopping methods have also been discussed above. See *supra* notes 73 to 78.

to treaty benefits if they would have received the income directly. If they are not entitled to treaty benefits, then the corporation is not entitled to treaty benefits as it is deemed to be incorporated for the sole purpose of obtaining treaty benefits. In the Convention, the look-through approach is exemplified by Articles X (Dividends), XI (Interest) and XII (Royalties) which provide reduced rates only to income recipients that qualify as the beneficial owners of income. The second method, the exclusion approach, is aimed at conduit companies that benefit from special tax regimes that relieve them of residence taxation.⁵⁶⁸ Under the exclusion approach, entities that obtain domestic tax benefits or incentives from their country of residence are prohibited from obtaining treaty benefits. The exclusion approach is found in the Protocol in Article 5 (Dividends) of the Protocol (Article X of the Convention) which prevents RICs and REITs from receiving treaty benefits. These entities are essentially tax exempt conduit companies and thus not entitled to treaty benefits. The third method, the subject to tax approach, eliminates treaty benefits to persons who are not subject to tax on their income in either of the contracting states.⁵⁶⁹ Under the subject to tax approach, treaty benefits can only be obtained for items of income that are received from entities that are subject to tax in their country of residence. The fourth and final method is the channel or use of income approach, whereby companies that apply substantial portions of their income to satisfy obligations to non-resident controlling shareholders or associated persons would be denied treaty benefits.⁵⁷⁰ The Protocol includes the channel approach in its base reduction tests.

The general nature of the OECD and U.N. approaches may lead to overkill. Thus, the OECD Commentary states that in determining which of the above methods to incorporate, states should consider the degree to which conduit companies inappropriately obtain treaty benefits and the scope of *bona fide* legal activities that such provisions might inadvertently affect.⁵⁷¹ Further the Commentary asserts that it is essential when

⁵⁶⁸ See *supra* note 1 at 575.

⁵⁶⁹ *Ibid.*

⁵⁷⁰ *Ibid.* at 576.

⁵⁷¹ See *supra* note 16 at 967.

implementing these provisions that they must be accompanied by provisions that will ensure that treaty benefits are not denied in *bona fide* situations. One central problem with the LOB provisions in U.S. tax treaties is that they are so specific that there is no room for *bona fide* clauses.⁵⁷² The LOB articles are drafted in such a way that every situation that the U.S. considers to be *bona fide* is extensively and exclusively described and all other situations that do not fit within this narrow framework are denied treaty benefits.⁵⁷³ The LOB Article in the Protocol is lacking a general provision that provides treaty benefits to *bona fide* non-treaty shopping activities, other than the competent authority provision that places the onus on the taxpayer to demonstrate their entitlement to benefits.

The ALI Tax Treaty Project, after criticizing the LOB provisions in U.S. tax treaties for failing to provide treaty benefits to a large number of legitimate business activities, also suggested an excellent alternative; a three tiered approach to implementing LOB provisions.⁵⁷⁴ First, the U.S. should include comprehensive LOB articles in tax treaties with tax havens. Second, the U.S. should include less comprehensive provisions in treaties with less developed countries in order to foster trade and investment in these countries. Finally, the U.S. should have the least comprehensive and liberal LOB articles in tax treaties with highly developed countries. By implementing such a three tiered approach the U.S. would simultaneously satisfy its anti-treaty shopping policies and the prevention of double taxation by ensuring that *bona fide* taxpayers are not denied treaty benefits by overly strict LOB provisions.

⁵⁷² See *supra* note 551 at 23.

⁵⁷³ *Ibid.* The competent authority discretion in Article 18(6) of the Protocol can be seen as the ultimate *bona fide* safety net. However, as described above in Problems with Competent Authority Discretion: section, there are several problems with this option.

⁵⁷⁴ See *supra* note 11 at 164.

Amendments:

A treaty is an agreement between two states, and binds them as a matter of international law.⁵⁷⁵ The process of treaty making differs from the process of enacting domestic tax legislation. In the U.S. treaty negotiations are initiated either by the United States Treasury Department, through the Office of the International Tax Counsel, or by the Treasury Department's foreign counterpart.⁵⁷⁶ The Treasury Department will announce that negotiations are under way and invite interested parties to submit comments. The negotiations themselves are held in secret. After first drafts are exchanged negotiations between the contracting states begin. Once the treaty is agreed to, it is signed and finally made public. On the U.S. side, the treaty must be ratified by the U.S. Senate. First it is reviewed by the Committee on Foreign Relations and then subjected to a vote by the full Senate. After the treaty passes a vote in the Senate, instruments of ratification are exchanged, usually within a short period. In Canada tax treaty negotiations are handled by the Department of Finance. After the treaty is agreed to and signed, it must be enacted by the Parliament of Canada pursuant to an implementing act that approves the treaty and declares it to have the force of law in Canada.⁵⁷⁷ Each implementing act contains a provision that gives priority to the treaty over any inconsistent Canadian law.⁵⁷⁸

Unlike tax legislation and regulations, the proposed text of treaties and the technical explanations are published too late to enable the public to participate in and influence the treaty making process.⁵⁷⁹ However, there is always the possibility of amending the treaty in the future to rectify unsatisfactory provisions. In fact, possibly in recognition the potential problems the LOB Article may cause, the Protocol in Article

⁵⁷⁵ See *supra* note 33 at 872.

⁵⁷⁶ See *supra* note 579 at 478–79.

⁵⁷⁷ *Ibid.*

⁵⁷⁸ See *supra* note 33 at 872–73. However, the granting of priority to a treaty is not absolute, Parliament can enact legislation that overrides the provisions of a treaty. If Parliament enacts legislation that overrides a treaty provision, Canadian courts will require it to do so explicitly in recognition of the fact the treaties are international obligations that are entitled to appropriate respect.

⁵⁷⁹ See *supra* note 418 at 477.

20(1) provides that in three years from the date it enters into force, January 1, 1996, Canada and the U.S. shall consult with respect to the rules in the LOB Article. Thus, on January 1, 1999, Canadian and American negotiators will meet to consider whether the LOB Article should stand as it is or be renegotiated. In this section, I shall outline some proposals that I believe should be incorporated into the LOB Article when it comes up for renegotiation. These proposals are intended to not only rectify some of the LOB Article's potential problems but also take account of the Canada and the U.S. close economic ties and increasing commercial integration as a result of the FTA and NAFTA. The other alternative, one which I favour and which may be evident from my critical analysis of the LOB Article, is the complete abolishment of this Article from the Protocol and its replacement with a general provision modeled after paragraph 7 of the LOB Article that allows Canada and the U.S. to apply their general anti-abuse rules to prevent treaty shopping. However, I recognize that U.S. tax treaty policy, for the moment at least, is fixated on the inclusion of LOB articles in all U.S. tax treaties, and I am almost certain that neither the Treasury Department nor the U.S. Senate would ever agree to the removal of the LOB Article from the Protocol.

One of the primary models on which I am basing some of my proposals is the U.S.-Mexico Tax Treaty because this treaty recognizes and makes provision for Mexico's membership in NAFTA.⁵⁸⁰ Similarly, I shall use provisions from the U.S.-Netherlands Treaty as a model for some of my proposals as this treaty also recognizes the Netherlands membership in the EC. Further, the Dutch were successful in incorporating several innovative provisions that are designed to protect their status as a location for international holding and investment corporations. Of course, I shall also make reference to recommendations for anti-treaty shopping provisions put forth by the ALI and the OECD.

⁵⁸⁰ Standage describes the U.S.-Mexico Tax Treaty as significant because it will facilitate NAFTA by removing tax barriers to the free exchange of goods and services and the free movement of capital and persons. *See supra* note 3 at 165.

A. Proposals to Reform the Publicly Traded Corporation and Subsidiary of a Publicly Traded Corporation Tests:

Under the publicly traded test in paragraph 2(c) of the LOB Article a company or trust whose principal class of shares are substantially and regularly traded on a recognized exchange is a qualifying person. Recognized exchanges are defined in paragraph 5(a) as the NASDAQ system, any exchange recognized by the SEC as a national exchange, Canadian stock exchanges that are prescribed stock exchanges under the ITA, and any other exchange agreed upon by the contracting states or competent authorities. As it stands the publicly traded company test is satisfactory for determining a person's status as a qualifying person, with one exception. This test, as the majority of the tests in the LOB Article, does not make any provision for, or recognize, Canada's membership in NAFTA.

I agree with Streng when he queries whether, as a result of NAFTA, Canada and Mexico should be treated as one country for the purposes of applying the LOB provisions in their respective treaties with the U.S.⁵⁸¹ Several countries, such as those in the EC and NAFTA, have entered into multilateral trading relationships with the objective of amalgamating their economies. In order to avoid hindering the operation of these economic trading arrangements their existence should be acknowledged in the LOB provisions of U.S. tax treaties.

The LOB Article in the U.S.-Mexico Tax Treaty recognizes the tri-party nature of NAFTA by granting treaty benefits even if non-U.S. and non-Mexican residents of NAFTA member countries participate in the ownership of, or receive compensation from, an entity seeking treaty benefits. Similarly, the U.S.-Netherlands Treaty recognizes the Netherlands multilateral economic association in the EC. Although the Mexico and Netherlands' treaties predate the Protocol, it is inexplicable why the LOB Article in the Protocol does not include analogous provision relating to Canada's membership in NAFTA.

⁵⁸¹ See *supra* note 201 at 48 and footnote 160.

With respect to the publicly traded test in paragraph 2(c) I suggest that the definition of recognized exchange in paragraph 5(a) should be expanded to include other stock exchanges located in NAFTA member states. Such a change would provide treaty benefits to Canadian residents organized as joint ventures with Mexican and U.S. partners, but are only listed on Mexican exchanges.⁵⁸² This would fulfill the policy of encouraging free trade and investment under NAFTA and does not increase the potential for treaty shopping.

Under paragraph 2(d) of the LOB Article in the Protocol, the subsidiary of a publicly traded company is also a qualifying person if more than 50 percent of its vote and value is owned by five or fewer publicly traded companies who are qualifying persons under paragraph 2(c). My first proposal to reform this provision would be to remove the limitation of five or fewer companies owning the subsidiary. This limit does not seem to have any purpose, other than administrative convenience. Conceivably this limit could be included to ensure that only publicly traded companies that are connected to the subsidiary, so that each publicly traded company owns at least 10 percent of the subsidiary, qualify.⁵⁸³ If this is the purpose behind the limitation then I suggest that the limitation be reworded to state that each of the publicly traded companies own at least 10 percent of the subsidiary. This would avoid the situation where a subsidiary is denied treaty benefits because 10 publicly traded companies, who are qualifying persons, each own 10 percent of the subsidiary.

My second recommendation would be to model paragraph 2(d) along the lines of comparable provisions in the Mexico and Netherlands Treaties. The publicly traded test in

⁵⁸² It is probably unlikely that a Canadian resident corporation conducting joint venture activities in Mexico would only be listed on a Mexican stock exchange. However, there may be some reasons for such a structure. For instance Mexican financing or securities laws may require listing first on a Mexican exchange, or the project may not be large enough to justify listing on both Mexican and Canadian exchanges.

⁵⁸³ However, I am not convinced that this limitation relates to the desire for publicly traded companies to be connected to the subsidiary. The comparable provision in the Netherlands Treaty, Article 26(1)(c), also contains the same limitation of five companies. However, under the U.S.-Netherlands Tax Treaty companies are connected, and thus entitled to reduced withholding rates on dividend payments, only if the parent owns 25 percent or more of the subsidiary. Thus I would argue that the five company limit is an arbitrary limit imposed for administrative convenience.

the U.S.–Mexico Treaty includes a third category of qualifying persons that is not included in the Protocol.⁵⁸⁴ This third category includes companies that are not publicly traded but are wholly owned by publicly traded companies which are a resident of any state that is a signatory to NAFTA and more than 50 percent owned, directly and indirectly, by publicly traded that are residents of either the U.S. or Mexico. While this third category does not provide any advantage over the test in the Protocol, since under both tests a resident corporation that is more than 50 percent owned by publicly traded corporations traded on recognized exchanges in the contracting states will be qualifying persons. What is important is that Mexico was successful in including in this test some recognition of its status as a member of NAFTA. Canada should have made some attempt to include a similar type of recognition. I would suggest something similar to the test in the Netherlands Treaty.

Paragraph 1(c)(iii) of Article 26 in the U.S.–Netherlands Tax Treaty provides treaty benefits to a company where at least 30 percent of its vote and value is owned by five or fewer publicly traded companies resident in the Netherlands and at least 70 percent of its vote and value is owned by five or fewer publicly traded companies resident in the U.S. or EC member state.⁵⁸⁵ This test makes provision for the Netherlands membership in the EC. It recognizes that certain companies resident in the Netherlands will be subsidiaries of EC residents and provides them with treaty benefits on the basis that they will not likely be engaged in treaty shopping. Further, this test is an attempt not to inhibit the economic arrangements that the EC is designed to foster. The subsidiary of publicly traded company test in the Protocol, paragraph 2(d), should likewise contain similar provisions. While I shall not venture to suggest the specific ownership requirements such a provision should have, as I am not certain what the optimal figures should be, I would propose something along the lines of the provision in the Netherlands Treaty. The modified provision in the protocol should specify a minimum amount of ownership by Canadian and U.S. qualifying persons, for instance 30 percent, and a minimum amount of

⁵⁸⁴ Article 17(1)(d)(iii), *see* Appendix Five.

⁵⁸⁵ *See* Appendix Four.

ownership by NAFTA residents, such as 70 percent.⁵⁸⁶ Of course such a reform would also necessitate modifying the definition of recognized exchanges to include stock exchanges in NAFTA countries.

B. Proposals to Reform the Ownership and Base Erosion Tests:

Paragraph 2(e) of the Protocol states that a company or trust will be a qualifying person if 50 percent of the vote and value of its shares is not owned by persons other than qualifying person or citizens or residents of the U.S. and less than 50 percent of its expenses deductible from gross income are paid to non-qualifying persons.

The ALI suggests that the analysis in the base erosion test, which dictates that less than 50 percent of deductible expenses should go to non-qualifying persons, is incomplete. The additional inquiry they suggest is whether the payments flow through the treaty country without attracting treaty country income tax cost.⁵⁸⁷ If the payment attracts a withholding tax in the residence treaty jurisdiction then the treaty objective of transferring taxation under a tax treaty from a source basis to residence basis would not be frustrated.⁵⁸⁸ The ALI suggest a base erosion test that in addition to the current base erosion restriction includes a second base erosion test which grants treaty benefits if 'less than 50 percent of gross income is used to make payments, which are deductible by the entity, to non-qualifying person or the payments are subject to a withholding tax in the treaty country of 15 percent.'⁵⁸⁹ This approach provides treaty benefits to entities controlled by non-residents when the payments they receive are subject to tax in the

⁵⁸⁶ Under such a provision a subsidiary would qualify for treaty benefits if it were owned 30 percent by U.S. and Canadian publicly traded companies and 40 percent by Mexican publicly traded companies. This provision will become more relevant if the membership of NAFTA is expanded in the future. Thus if Chile becomes the next member of NAFTA, a joint venture resident in Canada that is equally owned by publicly traded corporations in the U.S., Canada, Mexico and Chile will be a qualifying person.

⁵⁸⁷ See *supra* note 11 at 16.

⁵⁸⁸ See *supra* note 201 at 33. The Commentary to the OECD Model Convention suggests this type of approach. The Commentary suggests a subject-to-tax approach, based on the policy that the objective of tax treaties is to prevent double taxation and not tax immunity. See *supra* note 552 at C(1)-6, Commentary on Article 1.

⁵⁸⁹ See *supra* note 11 at 169. The exact text of the ALI recommendation is:

(B) Fifty percent or less of the gross income of the entity is used, directly or indirectly, to make (a) payments to persons not entitled to the benefits of the treaty (other than those resident in the source country) or (b) payments which are deductible by the entity and subject to withholding tax in the treaty country at a rate at least [15 percent].

residence state. I propose that such a provision be included in the base erosion test in the Protocol since it also satisfies the goal of preventing treaty shopping and may avert the denial of treaty benefits to *bona fide* taxpayers. However, I have a suspicion that U.S. negotiators would be wary of including such a provision as it may increase the amount of Canadian withholding tax revenue while decreasing the amount of U.S. revenue, because entities that formally were subjected to the maximum U.S. rate would be entitled to reduced rates.

The base erosion test in paragraph 1(f)(ii) of Article 17 of the U.S.–Mexico Treaty provides that less than 50 percent of gross income can be used to meet liabilities to persons who are not entitled to benefits under paragraphs (a), (b), (d) or (e). As discussed above paragraph 1(d) of this Treaty makes provision for ownership of subsidiaries by publicly traded entities resident in NAFTA member states. This is also recognized in the base erosion test as deductible payments can be made to these corporations without affecting a taxpayer's ability to qualify for treaty benefits. The ownership and base erosion test in the U.S.–Netherlands Treaty is found in Article 26(1)(d). The ownership test portion is exactly the same as in the Protocol, however the base erosion portion of this test, which is found in paragraph 5, is significantly different. The base erosion test in that Treaty provides the same test as in the Protocol, but in addition makes provision for the Netherlands membership in the EC.⁵⁹⁰ This test states that the base erosion test is met if (a) less than 50 percent of a person's gross income is used to make deductible payments to non-qualifying persons or (b) less than 70 percent is used to make deductible payments to persons who are not qualifying persons and less than 30 percent is used to make deductible payments to persons who are not qualifying and not residents of EC members states. Further, the base erosion test in the Netherlands Treaty includes comprehensive definitions of "gross income" and "deductible payments," which the Protocol is unfortunately lacking.

⁵⁹⁰ See discussion in text following *supra* note 588.

A reformed base erosion test should, in addition to the subject to tax provision discussed above, include a provision that allows deductible payments to be made to qualified persons resident in NAFTA member states. American treaty negotiators should not find this objectionable as such a provision would not affect the base erosion test's ability to prevent treaty shopping and it would prevent conflicts with NAFTA's policy of encouraging free trade. Further, these same negotiators agreed to similar provisions in their treaties with Mexico and the Netherlands, thus they should not object to the inclusion of an analogous provision in the Protocol. Finally, in order to alleviate any current vagueness in the base erosion test it should include a comprehensive list of definitions as the Netherlands Treaty does.

C. Proposals to Reform the Active Business Test:

The active business test in paragraph three of the Protocol provides that a non-qualifying person will be entitled to treaty benefits for U.S. source income if they are engaged in the active conduct of a trade or business in Canada, they earn U.S. source income in connection with or incidental to a Canadian business and the Canadian activity is substantial in relation to the U.S. activity. One problem with the active business test is that it does not recognize that increasingly the equity ownership of international businesses are held by persons from several jurisdictions. The ALI proposed that persons or entities from different countries with the same source country should be able to establish a legal entity in any of the countries and derive income that qualifies for treaty benefits under the active business test.⁵⁹¹ The income tax treaty to be applied would be the treaty in force

⁵⁹¹ See *supra* note 11 at 169-70, 174. The ALI calls this test the "Multi-treaty-resident test," it reads as follows:

(iv) A multi-treaty-resident test. Treaty benefits will be available to a legal entity resident in the treaty country if:

- A) it is engaged in that country in the active conduct of a business which is substantial in relation to its activities in the source country;
- B) the income in question consists of:
 - I) profits derived from the active conduct of a business directly carried on by it in the source country; and/or
 - II) dividends, interest, or royalties received from a controlled company which is engaged, directly or through subsidiaries, in the active conduct of a business in the source country;

and the business carried on in the source country is substantial in relation to the business activities in the country of residence; and

with the country in which the legal entity is resident, not where the owners are resident. Under the ALI proposal, in order for a legal entity would be required to meet the active business test, it must be engaged in the active conduct of a trade or business that is substantial in relation to its activities in the source country. Additionally, a significant portion of the outstanding stock of the legal entity is required to be owned by qualified residents of one or more countries with which the source country has a tax treaty. Streng states that the objective is to protect legitimate international joint ventures. Thus, the ALI proposal states that two-thirds should be owned by qualified residents of the source country or qualified residents of a country with a comprehensive tax treaty with the source country, one-third of the outstanding stock should be owned by qualified residents of a treaty country and no more than one-half should be held by residents of one country.⁵⁹² Streng further states that this test recognizes the increase in the use of cross-border business structures for holding active business operations, particularly entities in highly industrialized countries where the potential for tax abuse is diminished.⁵⁹³ I would also recommend the addition of a multi-treaty-resident test such as the ALI proposal. Such a test would provide treaty benefits to multinational corporations or international joint ventures that are engaged in *bona fide* non-treaty shopping activities. Further, this test does not increase the danger of treaty shopping since, as under the derivative benefits test, only entities resident in countries with comprehensive tax treaties the U.S. can utilize it.

While the active business test in the U.S.-Mexico Treaty is essentially the same as that in the Protocol, the test in the U.S.-Netherlands Treaty contains some provisions that I believe should be included in the Protocol. The basic active business test in the

C) of its total outstanding stock:

- III) at least [2/3] is owned by persons or entities that are qualified residents of the source country or one or more countries with which the source country has entered into a comprehensive income tax treaty
- IV) at least [1/3] is owned by qualified residents of the treaty country; and
- V) no more than [1/2] is held by residents of any one country.

For purposes of (A) and (B) a business shall not include making or managing investments unless those activities form part of the active conduct of a banking or insurance business by a bank or insurance company.

⁵⁹² See *supra* note 201 at 41.

⁵⁹³ *Ibid.* at 41-2.

Netherlands Treaty is found in Article 26(2)(a) and is essentially the same as the test in the Protocol. The first advantage of the test in the Netherlands Treaty compared to the Protocol are the definitions found in subparagraphs (b) through (g), which are not in the Protocol. These subparagraphs clarify the application and remove some of the vagueness of the active business test. Subparagraph (b) defines “income derived in connection with” as an income producing activity that forms part of or is complementary to the active trade or business. Subparagraph (c) is also an important addition as it removes the subjectivity of the “substantiality” requirement of the active business test. This subparagraph, although criticized for being long and complex, provides a safe harbour taxpayers can aim for by listing ratios for the value of assets, gross income and payroll expenses of the active business compared to the income derived in connection with or incidental to the U.S. income producing activity. These safe harbours have a low threshold and can be easily be met, the minimum average of the three ratios is only 10 percent. Subparagraph (d) is also important as it defines “incidental income” as income that facilitates the conduct of the trade or business, such as the investment of working capital. Also vital is the subparagraph (e) which outlines seven ways a person will be considered to be engaged in the active conduct of a trade or business. Finally, subparagraphs (f) and (g) are useful as they define “controlling beneficial interest” and “common control.” I propose that the active business test in the Protocol also include provisions, such as those in the Netherlands Treaty, that explain the currently undefined terms in the Protocol’s test.

Paragraph 2(h) of the Netherlands LOB Article includes a second active business test for entities engaged in the active conduct of a trade or business in the Netherlands and a component part of that activity is also conducted in another member state of the EC. The entity resident in the Netherlands may elect to treat some or all of the activity conducted in an EC state as if it were conducted in the Netherlands provided that the ratio of the ratio of the value of assets, the ratio of gross income and the ratio of payroll expenses in the Netherlands is at least 15 percent of those values in the EC member states. The active business test in the Protocol should likewise include an alternative active business test for Canadian resident entities that conduct part of their active business in

NAFTA countries other than the U.S. Currently the active business test in the Protocol is limited to active businesses conducted in Canada. This should be expanded to include all active business operations in NAFTA countries. If U.S. negotiators find such a provision objectionable because it may not be certain that future NAFTA members will have a tax treaty with the U.S. then the second active business test could be limited to those NAFTA countries with a comprehensive U.S. tax treaty.

Further, there is a third active business test in the Netherlands Treaty, which is absent from the Protocol and every other U.S. tax treaty. This is the so called headquarters clause in Article 26(3).⁵⁹⁴ This provision provides a safe harbour for Dutch headquarters companies of a multinational corporate group. To qualify a holding company must be responsible for the overall supervision and administration of the group, the corporate group must be engaged in an active business in at least five countries, less than 50 percent of the group's gross income can be generated in a any state other than the headquarters company's state of residence, less than 25 percent can be generated in the other contracting state (i.e. the U.S.), and the income derived from the contracting state is derived in connection with or incidental to the active business of the group. This safe harbour was included at the insistence of Dutch negotiators to protect the Netherlands as an international financial center.⁵⁹⁵ Canadian negotiators should also insist on the inclusion of a similar provision in the Protocol when they consult with their American counterparts as to changes in the LOB Article. While Canada is not an international financial center as the Netherlands is, such a provision should be included in the Protocol in recognition of Canada's and the U.S. close economic ties and the fact that little treaty shopping occurs between Canada and the U.S. Additionally, since the U.S. agreed to the inclusion of a headquarters active business test in its tax treaty with the Netherlands, which was and still is one of the preferred locations for treaty shopper's holding

⁵⁹⁴ Goossen has been proven wrong when he stated that it may be expected that this safe harbour may become the standard for determining whether a holding company conducts an active trade or business as this is the only U.S. tax treaty to date that include such a provision. See *supra* note 551 at 33.

⁵⁹⁵ See *supra* note 551 at 33. Example VII of the MOU to the U.S.-German Treaty also recognizes a joint venture company that acts as a head quarters company as an entity entitled to treaty benefits under the competent authority provision.

companies, the U.S. should have little objection to including such a provision in the Protocol.

D. Proposals to Reform the Derivative Benefits Test:

The derivative benefits test in the Protocol provides treaty benefits to a resident of Canada for dividends, interest and royalties sourced in the U.S. if more than 90 percent of the vote and value of the Canadian resident is owned by qualifying persons, residents or citizens of the U.S., or other persons who are residents of a country which the U.S. has a comprehensive tax treaty under which they are entitled to all the benefits; they would if resident in Canada qualify for treaty benefits under the Protocol as a result of being a qualifying person or because of the active business test; and finally they are entitled to a rate of withholding under their country's tax treaty with the U.S. at least as low as the rate in the Protocol. Additionally, a standard base erosion test must be met. The derivative benefits test in the U.S.–Mexico Treaty, Article 17(1)(g), is broader than the test in the Protocol. The test in the Mexico Treaty provides treaty benefits if 30 percent of a resident's beneficial ownership is owned by qualifying persons and 60 percent is held by persons resident in NAFTA member states.⁵⁹⁶ Further, the base erosion test is looser than that in the Protocol. The base erosion test in Mexico's derivative benefits test states that less than 70 percent of gross income can be used to meet liabilities to persons not entitled to treaty benefits and less than 40 percent of gross income is used to meet liabilities to persons who are neither qualifying persons nor residents of NAFTA. Similarly the derivative benefits test in the U.S.–Netherlands Tax Treaty provides treaty benefits to residents of the Netherlands if more than 30 percent of their vote and value is owned by qualifying persons resident in the Netherlands, more than 70 percent is owned by person resident in an EC member state and either the standard base erosion test is met or a modified EC base erosion test is met, whereby less than 70 percent of gross income is used to make deductible payments to non-qualifying persons and less than 30 percent of

⁵⁹⁶ Currently, residents of Canada are the only third country residents able to take advantage of this provision. However, the article is not restricted to only residents of Canada, but is open ended so that future members of NAFTA, which have a comprehensive U.S. tax treaty, can qualify for derivative benefits.

gross income is used to make deductible payments to non-qualifying persons who are not residents of EC member states.

The provision of treaty benefits to NAFTA countries in the derivative benefits article of the U.S.-Mexico treaty is designed to facilitate NAFTA's goal of not hindering trade and investment between signatories of NAFTA.⁵⁹⁷ The test in the Mexico Treaty will provide treaty benefits to many entities that would be subject to double taxation for failing to qualify under one of the objective tests in the LOB article.⁵⁹⁸ As already stated, it is inexplicable why a similar provision was not included in the LOB Article in the Protocol. Thus I propose that the derivative benefits test in the Protocol be modified to include a similar provision to the one in the U.S.-Mexico and U.S.-Netherlands' tax treaties. Such a provision would be preferable to the current provision as more Canadian residents would be able to qualify for treaty benefits. Since not only is the threshold lower for qualifying under the tests, but only 60 percent of an entity's vote and value in the case of Mexico and 70 percent in the case of the Netherlands is required to be owned by qualified persons and residents of NAFTA or EC countries compared to a 90 percent threshold in the Protocol. Those tests also do not include the complicated test in the Protocol that other persons must satisfy. The derivative benefits tests in the U.S.-Mexico and U.S.-Netherlands treaties make no reference to other persons who are resident in a country the U.S. has a comprehensive tax treaty with, under which they are entitled to *all* benefits, and that they *would* qualify for treaty benefits under the Protocol as a qualifying person or under the active business test *if* they were a resident of Canada, and that they are entitled to a rate of withholding in their country of residence's tax treaty with the U.S. at least as low the applicable rate in the Protocol. This complicated test is forsaken in the U.S.-Mexico and U.S.-Netherlands treaties in favour of their less complicated tests that only make reference to share ownership by qualifying persons and persons resident in either NAFTA or the EC countries with a comprehensive U.S. tax treaty. Additionally, the derivative benefits tests in the U.S.-Mexico and U.S.-Netherlands treaties include base erosion tests that allow a

⁵⁹⁷ See *supra* note 291 at 239.

⁵⁹⁸ *Ibid.*

larger percentage of deductible payments to go to non-qualifying persons who are resident in NAFTA or the EC countries. In recognition of the growing importance, and possible expansion, of NAFTA I would enthusiastically support incorporating a similar derivative benefits test in the Protocol. In fact, I would also propose to further modify the tests in the U.S.-Mexico and U.S.-Netherlands treaties by combining the test currently in the Protocol with the test in the U.S.-Mexico Treaty. Under my proposed derivative benefits test, a resident of Canada would be entitled to treaty benefits if they met the current test or if they met a test similar to the one in the U.S.-Mexico treaty. Under such a provision Canadian residents engaged in *bona fide* activities who are owned by residents of NAFTA member states or who satisfy the current derivative benefits test which does not require any local Canadian or NAFTA ownership will be will be entitled to treaty benefits.⁵⁹⁹

E. Additional Provisions:

Article 26(6) of the U.S.-Netherlands Tax Treaty provides treaty benefits to entities engaged in shipping and air transport that are more than 50 percent owned by residents of a third country or the stock of the corporation is primarily and regularly traded on a recognized exchange in a third country. While I am not sure of the extent to which the Canadian shipping and air transport industry is owned by residents in third countries, or its shares traded on the stock exchanges of third countries, if this is significant then Canadian negotiators should consider demanding the inclusion of a similar provision in the LOB Article of the Protocol.

F. Modification of Competent Authority Discretion:

Paragraph 6 of LOB Article in the Protocol includes a safety net for Canadian residents that are not entitled to treaty benefits under any of the LOB Article's provisions. This provision states that where a Canadian resident is not entitled to treaty benefits, the

⁵⁹⁹ The current derivative benefits test provides treaty benefits to Canadian entities that are 90 percent owned by residents of a third country which have a comprehensive tax treaty with the U.S., and meets other conditions. This is not possible under the tests in the U.S.-Mexico and U.S.-Netherlands' treaties. Thus in order to preserve this avenue for treaty benefits, I propose that this part of the derivative benefits test, although complicated, be preserved.

person can request the U.S. competent authority to determine whether, on the basis of the person's history, structure, ownership and operations, its creation and existence did not have as a principal purpose the obtaining of treaty benefits that otherwise would not be available, or that it would not be appropriate to deny treaty benefits. The Canadian resident must be granted treaty benefits if the competent authority answers either of these two questions in the affirmative. The problem with this test is its subjective nature and the lack of objectively defined criteria that applicants should meet.

The competent authority discretion provision in the LOB Article should be modified to include some objective criteria that give taxpayers an idea of their ability to qualify under this test. Amending this provision in such a fashion will remove some of its current uncertainty, but will still allow it to be flexible enough to provide treaty benefits to *bona fide* recipients. The ALI identified several factors that can be used as objective criteria to determine if an entity was or was not engaged in treaty shopping.⁶⁰⁰ These factors are: (1) whether the overall level of taxes imposed on the income has been significantly reduced through the imposition of the legal entity; (2) whether, even if there was a reduction, the treaty country imposes a substantial level of taxation on the income; (3) whether, if the owners of the entity are resident in a country with a tax treaty with the source country, the same or similar treaty benefits would have been available had the investment been made directly through an entity resident in such country; (4) whether the entity is newly formed or long standing and whether it arose through an acquisition or merger; (5) whether the invested capital was generated in the normal course of business or was borrowed; (6) whether the entity holds investments or conducts activities in other countries which are similar or related to the investment activity in the source country; and (7) any other factors suggesting that business considerations dictated the creation or utilization of the legal entity.⁶⁰¹ The objective of these tests is to determine whether the

⁶⁰⁰ See *supra* note 11 at 171-72.

⁶⁰¹ Similarly the branch tax profits regulations contain several factors that can be considered under its competent authority provision. Under that provision, the Commissioner of the IRS may take into consideration the following eight factors when determining whether a non-U.S. corporation is a qualified resident: (1) Business reasons for establishing and maintaining the corporation; (2) Date of incorporation compared to date that applicable U.S. bilateral treaty was entered; (3) Continuity of the historical business and ownership; (4) Extent to which the corporation satisfies one or more of the tests of section 884; (5) Extent to which U.S. trade or business is

combined tax burden of the source and resident countries has been manipulated to reduce the overall tax burden below normal levels.⁶⁰²

Similarly, paragraph XIX of the MOU to the U.S.–Netherlands Tax Treaty contains six specific factors that can be considered by the competent authority in deciding whether treaty benefits should be granted.⁶⁰³ These factors are very similar to those proposed by the ALI. Essentially, they are a summary of the LOB concept as they describe situations that qualify as *bona fide* transactions entitled to treaty benefits.⁶⁰⁴ The MOU to the U.S.–German Tax Treaty also provides a list of factors that will be taken into consideration by the competent authority.⁶⁰⁵

The competent authority provision in the LOB Article, or at least its Technical Explanation, should include a list of factors similar to those proposed by the ALI or those included in the MOU to the Netherlands and German treaties. This would improve the competent authority provision as taxpayers would have a guide against which to judge whether they will be entitled to treaty benefits by the U.S. competent authority. In addition to providing some certainty, such a list may also decrease the number of frivolous applications for rulings as taxpayers who do not fulfill any of the criteria may more than

dependent on capital, assets, or personnel of the company; (6) Whether the company is a recipient of special tax benefits in the residence-country; (7) Whether the corporation is a member of an affiliated group; and (8) Extent to which the corporation would be entitled to comparable treaty benefits with respect to the income tax treaty that would apply to that corporation if it had been incorporated in the country or countries of residence of the majority of its shareholders. Treas. Reg. 1.884-5(f)(2)(i)–(viii). These factors are very similar to those proposed by the ALI.

⁶⁰² See *supra* note 201 at 43.

⁶⁰³ These factors are: (1) The date of incorporation of the corporation in relation to the date that this Convention entered into force; (2) The continuity of the historical business and ownership of the corporation; (3) The business reason for the corporation residence in its State of residence; (4) The extent to which the corporation is claiming special tax benefits in its country of residence; (5) The extent to which the corporation's business activity in the other state is dependent on the capital, assets, or personnel of the corporation in its State of residence; (6) The extent to which the corporation would be entitled to treaty benefits comparable to those afforded by this Convention if it had been incorporated in the country of residence of the majority of its shareholders. See *supra* note 551 at 24.

⁶⁰⁴ *Ibid.*

⁶⁰⁵ These factors include: (1) the existence of a clear business purpose for the structure and location of the income earning entity; (2) the conduct of an active trade or business by the entity, instead of investment activity; and (3) a valid nexus between the entity and the activity giving rise to the income.

likely not be entitled to treaty benefits and thus will not want to incur the effort and expense of applying for a determination.

CONCLUSION

Most countries adopt a policy of allowing a free transfer of capital into, within and out of their borders. This freedom has made foreign trade and investment possible and enhanced opportunities for cross-border business.⁶⁰⁶ Such a policy is one method for building a world-wide market and developing international economic co-operation and integration.⁶⁰⁷ Investors are able to direct capital to those countries where they expect to derive the highest return and are able to react to changes in the political and economic climate by de-investing and directing funds to more favorable countries.⁶⁰⁸

In North America, the broad objective of NAFTA is to increase the welfare of the residents of each of the member countries. This occurs by reducing or eliminating barriers to the free flow of goods, capital and services among the member countries.⁶⁰⁹ The classic premise for free trade is that the welfare of consumers is maximized if the prices they pay for goods and services are not distorted by tariffs, export subsidies, taxes, or regulatory and administrative burdens.⁶¹⁰ Thus, consumers are best off when they pay the same price for a given product, whether produced domestically or abroad.⁶¹¹

Provisions in domestic tax legislation and bilateral tax treaties also have the potential to distort the amount and location of cross-border investment and trade.⁶¹² The necessity to remove or mitigate such barriers has led to the current system of bilateral tax treaties that seek to minimize the impact of double taxation. As discussed in the second chapter, the goals of tax treaties are the prevention of double taxation, the prevention of

⁶⁰⁶ See *supra* note 42 at 309.

⁶⁰⁷ *Ibid.*

⁶⁰⁸ *Ibid.*

⁶⁰⁹ See *supra* note 4 at 689.

⁶¹⁰ *Ibid.*

⁶¹¹ *Ibid.*

⁶¹² *Ibid.* at 699.

fiscal evasion and the promotion of stability. Double taxation should be avoided because of its harmful effects on the expansion of trade in goods and services, the movement of capital and persons, and because it seriously impedes the widening of economic relations.⁶¹³ The prevention of double taxation is usually accomplished by one state giving up its jurisdiction to tax. Usually it is the state with relationship jurisdiction that gives up its power to tax to the state with source jurisdiction. The prevention of fiscal evasion is usually accomplished through the mutual exchange of information regarding taxpayers and in some tax treaties, especially U.S. tax treaties, through anti-treaty shopping provisions. Finally, the goal of promoting stability ensures that taxpayers know, with a strong degree of certainty, the basis of taxation in each country.⁶¹⁴

The relative freedom of investing, the absence of restrictions on the formation of companies by foreign investors and the fact that taxes constitute an important cost factor that can be minimized, has resulted in an industry of tax experts who endeavor to reduce the tax burden on foreign investments.⁶¹⁵ These experts take advantage of the lack of a uniform tax treaty. They exploit the differences in the approach and content of the various tax treaties to minimize their client's tax burdens.⁶¹⁶ This is accomplished by routing investments from one country to another through a third (and fourth and fifth) country in order to benefit from differing tax treaties and various domestic tax laws. The use of such international tax planning, also referred to as treaty shopping by those who oppose it, has become widespread and countries have begun to take action to prevent the use of intermediary companies to obtain treaty benefits.

However, treaty shopping may not always be objectionable, and in the past it was not. Becker states that "[f]rom time to time, there seem to be waves of international opinion which, like fad or fashion, everybody accepts without critical scrutiny. Measures

⁶¹³ *Ibid.*

⁶¹⁴ *See supra* note 523 at 375.

⁶¹⁵ *See supra* note 42 at 309..

⁶¹⁶ *Ibid.*

against treaty shopping seem to be such a wave.”⁶¹⁷ Companies may be interposed in a country not necessarily for tax planning purposes, but they may have an economic reason. Corporations can be established in third countries to serve other markets. Additionally, they may be established in order to access capital markets, currency regulations or the political environment of that jurisdiction.⁶¹⁸ Further, sometimes corporate structures are not objectionable even though on initial investigation it seems as if they were engaged in treaty shopping. For example, if a multinational corporation with production facilities in one state develops a patent that it licenses to another state under the protection of a tax treaty, this looks like a stepping-stone treaty shopping situation but is in fact absolutely a *bona fide* transaction.⁶¹⁹ Finally, it has been argued that treaty shopping serves the permissible goal of attracting foreign capital to the country whose tax treaty is utilized for treaty shopping purposes.⁶²⁰ Without the cost advantage that treaty shopping provides this capital would not be invested in the host country as the increased withholding tax would be a strong disincentive. Situations such as the above example of licensing a patent are accepted as proper by the majority of international tax authorities. However, they can be treated as abusive or as conduit situations by anti-treaty shopping provisions in tax treaties. Thus, anti-treaty shopping mechanisms should be scrupulously investigated to determine if they are justified.⁶²¹

The old U.S.-Netherlands Tax Treaty represented one of the last and most notorious U.S. tax treaties that provided third country residents a permissible method for tax avoidance for their U.S. investments.⁶²² U.S. negotiators’ insistence on the inclusion of a strict LOB provision in new Netherlands treaty was entirely reasonable considering the amount of treaty shopping that occurred through the Netherlands and the Netherlands

⁶¹⁷ *Ibid.* at 339.

⁶¹⁸ *Ibid.*

⁶¹⁹ *Ibid.*

⁶²⁰ See *supra* note 324 at 987.

⁶²¹ *Ibid.*

⁶²² See *supra* note 204 at 778.

Antilles.⁶²³ However, that there is *no* reason why strict anti-treaty shopping provisions should be included in bilateral tax treaties in the North American free trade zone.⁶²⁴ The ALI Tax Treaty Project correctly observed that the U.S. has overreacted to the treaty shopping problem.⁶²⁵ The ALI stated that the 'rules which seem both necessary and appropriate when the focus is on tax haven jurisdictions such as the Netherlands Antilles and the British Virgin Islands seem less needed and more intrusive on normal international economic relationships when applied in treaties entered into with the world's leading industrialized countries – countries which generally have substantial economies and comprehensive tax systems.'⁶²⁶ This is exactly the case with the LOB Article in the Protocol. The ALI continued by stating that complex LOB provisions may have undesirably inhibitive effects on industrialized countries.⁶²⁷ Further, the ALI Tax Treaty Project determined that the ownership test, the publicly traded test and the active business safe harbour fail to apply to large number of legitimate situations because the underlying concept of these tests does not provide a reliable guide to legitimate business activities.⁶²⁸ Finally, the ALI concluded by indicating that LOB provisions should be made more flexible to enable the appropriate structuring of legitimate international transactions.⁶²⁹

The Canada–U.S., the U.S.–Mexico, and the Canada–Mexico Tax Treaties are vital components of NAFTA as they enhance NAFTA's principal purpose, the promotion

⁶²³ However, it is debatable whether the LOB article in the Netherlands treaty is as strict as the provision in the Protocol. Dutch negotiators refused to agree to the inclusion of an article that did not recognize and make provision for the status of the Netherlands as a location for international holding and finance companies. The Netherlands was an ideal location for holding companies desiring to minimize the withholding taxes they were subject to because its extensive tax treaty network and the lack of Dutch taxes on dividends paid out of profits not derived from the Netherlands. Thus, Dutch negotiators insisted on, and were successful in, including a LOB article in the Netherlands treaty that provides treaty benefits for headquarters companies, aircraft and shipping companies and recognizes the Netherlands' membership in the EC by permitting deductible payments to EC countries to be included in the active business and derivative benefits tests. Similar provisions are not included in the Protocol.

⁶²⁴ See *supra* note 4 at 732.

⁶²⁵ See *supra* note 11 at 165.

⁶²⁶ *Ibid.*

⁶²⁷ *Ibid.*

⁶²⁸ *Ibid.* 164.

⁶²⁹ *Ibid.*

of trade and investment in North America. To make treaty shopping worthwhile, the Canadian tax rate on a particular item of income must be lower than the U.S. withholding rate that would be applicable without treaty shopping. However, very little, or no, treaty shopping occurs from Canada into the U.S. because Canadian tax rates are generally higher. The LOB Article violates the free trade policy in NAFTA because it denies treaty benefits to Canadian resident entities engaged in cross-border trade or investment that are involved in treaty shopping. Additionally, the LOB Article is unnecessary in the North American free trade zone as there are other provisions in NAFTA designed to protect the member states from treaty shopping. For example, if a German company, whose target market is the U.S., entered the North American market through a Canadian branch or subsidiary, the country of origin rules in NAFTA would provide adequate protection to the U.S.⁶³⁰ Further, the investment article in NAFTA extends certain benefits to certain non-NAFTA investors.⁶³¹ Thus, the LOB provision is unnecessary and incompatible with NAFTA.⁶³²

If, however, a country, such as the U.S., insists on the inclusion of a LOB Article in all its tax treaties then it is important to strike a balance when drafting such provisions. A balance must be reached between an article that is restrictive enough to limit benefits to intended recipients and one that is not so restrictive that it chokes off *bona fide* trade and investment activities.⁶³³ A LOB article that is too restrictive can burden the type of trade and investment envisioned by multi-lateral trade arrangements such as NAFTA.⁶³⁴ One result of the LOB Article is that tri-party cross-border trade and investment that is intended to be encouraged by NAFTA may not qualify for treaty benefits and will be discouraged. Thus, a balance is needed between protecting the interest of tax authorities in preventing fiscal evasion and not defeating the policies of tax treaties and trade agreements in reducing double taxation and promoting trade.

⁶³⁰ See *supra* note 4 at 732-33.

⁶³¹ *Ibid.* NAFTA, Article 1101.

⁶³² *Ibid.*

⁶³³ See *supra* note 291 at 217.

⁶³⁴ *Ibid.* at 219.

A major obstacle to drafting anti-treaty shopping provisions is the extent to which *bona fide* claimants are denied treaty benefits. If there is a danger that a high proportion of claimants have to prove that they are entitled to relief, the operation of the treaty will be so cumbersome and the guarantee of relief so uncertain that the benefits the treaty is designed to provide will be lost.⁶³⁵ Because of this problem the U.N. Ad Hoc Group suggested that it would be more effective to deny treaty benefits only to those entities that are shown to not be *bona fide* recipients rather than providing benefits only to those who prove that they are *bona fide*.⁶³⁶ In other words potential recipients should have a presumption of innocence, instead of a presumption of guilt. The U.S., on the other hand, has the opposite focus. The LOB provisions in U.S. tax treaties are drafted from the viewpoint that companies, by their very nature, are conduit entities used by their shareholders for treaty shopping purposes.⁶³⁷ Companies, as distinguished from individuals and governments, are not entitled to treaty benefits.⁶³⁸ Companies will only be entitled to treaty benefits if they meet the strict criteria in the LOB provision. Thus companies, under a U.S. LOB provision, have to overcome a presumption of guilt in order to obtain treaty benefits, whereas under the OECD Model they are presumed innocent and entitled to benefits unless proven guilty of treaty shopping.

The LOB article is a reaction by the U.S. to its recent status as a capital importing nation because significant U.S. tax revenues are at stake when third country residents, particularly those from tax havens, are able to escape the maximum U.S. withholding tax on their U.S. source income. Additionally, the LOB provision significantly affects tax revenue flows between the U.S. and its major treaty partners. In most cases U.S. source income is not escaping taxation in the treaty partner country. What is occurring is that the

⁶³⁵ See *supra* note 1 at 577.

⁶³⁶ *Ibid.*

⁶³⁷ See *supra* note 551 at 19–20.

⁶³⁸ LOB provisions are directed against corporations, which are considered to be intermediate conduits engaged in treaty shopping without any proof to the contrary. This notion is supported by the fact that non-corporate entities, such as individual residents, governments and not-for-profit organizations, are generally unconditionally entitled to treaty benefits. See *supra* note 551 at 20.

LOB provision causes tax revenue to shift from the treaty country to the U.S.⁶³⁹

Although tax treaties are supposedly bilateral agreements, the ultimate effect of the LOB provision is a U.S. unilateral attempt to increase its tax revenues. The fundamental goal of tax treaties is the removal of the adverse effects of double taxation on the international movement of goods, services, capital, and people. Embracing a unilateral approach, not only places the United States in violation of international law, but also exposes U.S. businesses to retaliatory legislation by U.S. trading partners.⁶⁴⁰ The widespread disparity in approaches to anti-treaty shopping and LOB provisions indicates that there is no wholesale shift in favour of the U.S. *strong-arm* approach to LOB provisions.⁶⁴¹ The world has not, for good reason, decided to follow the U.S. lead on the inclusion of LOB articles in tax treaties.

The goal of my thesis is to scrupulously analyze the anti-treaty shopping provision, the LOB Article, in the Protocol to determine if it is justified. The methods I employed to accomplish this goal were to first examine the various provisions in the LOB Article. This involved analyzing each paragraph and discussing how they would likely be interpreted. Second, my analysis of whether the LOB Article is justified continued by discussing the potential problems these provisions may cause for Canadian residents and suggesting pitfalls and opportunities that tax practitioners should be aware of. Finally, my analysis concluded by comparing the provisions in the Protocol to those in other U.S. tax treaties, and proposals by the ALI and OECD. I conducted this comparison in order to determine if the LOB Article in the Protocol was justified by examining how it differed from analogous provisions in other U.S. tax treaties. I also conducted this comparison in order to develop proposals on how the LOB Article should be modified in the future when Canadian and U.S. tax authorities consult as to possible changes.

The conclusion of my analysis is that the LOB Article in the Protocol is not a justifiable method of preventing treaty shopping that may occur between Canada and the

⁶³⁹ See *supra* note 201 at 51.

⁶⁴⁰ See *supra* note 204 at 817.

⁶⁴¹ *Ibid.*

U.S. The LOB Article is difficult to apply in practice as it contains complex tests and many undefined and vague terms. The LOB articles in other U.S. tax treaties, such as the U.S.–Netherlands Treaty and the U.S.–German Treaty, contain comprehensive definitions in their LOB articles or in their accompanying MOUs or technical explanations, which unfortunately the Protocol does not. Further, the LOB Article has several potential problems and can have a negative impact on various Canadian residents not engaged in treaty shopping. In addition to potentially denying treaty benefits to foreign owned or controlled entities, this Article has the potential to deny treaty benefits to entities that are wholly Canadian owned and engaged in *bona fide* non-treaty shopping activities, such as highly leveraged companies, trusts with non-resident beneficiaries and privately controlled companies. Canadian resident entities which have, or plan to have, U.S. source income will be required to take into account the extremely complex rules of the LOB Article and plan appropriately whenever there is a change to their U.S. or Canadian businesses, a change in their corporate structure or chain of ownership, a change in ownership of their shares, or even a change in their creditors or suppliers or the level of payments to them. Further, Canadian entities engaged in cross-border business or investment will have to conduct regular reviews to ensure that they are in compliance with the LOB Article. Additionally, the Canadian Government will have to realize that the LOB Article has the practical effect of amending the definition of residence as only qualified persons, not mere Canadian residents, are entitled to the benefits of the Convention. Finally, the Canadian Government must also recognize that the LOB Article could have the unplanned effect of re-directing tax revenues from Canada to the U.S.⁶⁴²

I also maintain that the LOB Article is not justifiable as it violates two of the three goals of tax treaty policy: namely, the prevention of double taxation and the promotion of stability. The LOB Article contains several complex tests and undefined terms that will be interpreted and applied according to U.S. domestic tax law, laws which Canadian residents and their advisors will not be familiar with.⁶⁴³ Anti-treaty shopping provisions, by their

⁶⁴² See *supra* note 20 at 55.

⁶⁴³ Goossen concludes that because of the extreme intricacy of LOB provisions, practical application will focus on the safe harbours, the technical explanations and examples in MOUs, instead of on the basic tests. See *supra* note 551

very nature, introduce a level of uncertainty into the investment climate because the more rigorous the statute the greater the chance that the entity will not fulfill the criteria required to obtain treaty benefits.⁶⁴⁴ Therefore, the LOB Article fails to promote stability since taxpayers will not know with any degree certainty whether they qualify for treaty benefits under this provision. Second, the LOB Article does not prevent double taxation, but will actually increase the occurrences of double taxation. Many Canadian residents, previously entitled to treaty benefits, who are not engaged in treaty shopping will be unable to qualify for treaty benefits under this provision and will thus be subject to double taxation. Although, these taxpayers may be entitled to a foreign tax credit for the increased withholding tax they will be subject to, for reasons discussed earlier this may not provide adequate relief. Consequently, the LOB Article will result in an increased incidence of double taxation and a greater tax burden for some Canadian resident entities. In fact, it can be argued that the goal of preventing double taxation has been subsumed to the goal of preventing fiscal evasion to such a degree by the LOB Article that U.S. and Canadian tax treaty negotiators should consider renaming the Convention the "Convention with Respect to the Prevention of Fiscal Evasion", instead of its current title – the "Convention with Respect to Taxes on Income and on Capital."⁶⁴⁵

The inclusion of the LOB Article in the Protocol was not based upon rational decision making but was motivated by U.S. tax treaty negotiators' determination to stop treaty shopping at all costs. The LOB Article illustrates the obsession of U.S. tax treaty policy of eliminating treaty shopping over the basic goal of international tax treaties, which is the facilitation of trade and investment through the removal of tax deterrents to the free exchange of capital, goods and services. Canada should not have agreed to the inclusion of the LOB Article in the Protocol because its negative impact on certain Canadian entities

at 46. He fears that these extraneous explanations will then take on a life of their own and will result in an even more restricted application of the Treaty.

⁶⁴⁴ See *supra* note 1 at 573 discussing U.N. Study.

⁶⁴⁵ However, even though the central goal of the LOB Article is the prevention of fiscal evasion by eliminating treaty shopping, there, nonetheless, are other anti-treaty shopping methods that are equally effective and more equitable. Grady concluded that the LOB article has had little success in preventing treaty shopping. See *supra* note 200 at 656. Similarly, Kim states that LOB provisions have had limited effectiveness, as well as a lukewarm reception. See *supra* note 324 at 984.

and the Canadian economy will outweigh the benefits the Protocol provides in terms of reduced withholding and estate taxes. Canadian tax treaty negotiators who in three years are responsible for consulting with their American counterparts with respect to the LOB Article should make every effort to amend the Article and remove some of its negative effects. They should strive to convince their U.S. colleagues that what is needed in the case of most developed countries is not a strict LOB Article to combat treaty shopping, but a flexible approach.⁶⁴⁶ Only by amending the LOB Article in such a way will the goals in the U.S.-Canada Tax Convention and NAFTA, of preventing double taxation and encouraging free trade, be capable of being fully realized.

⁶⁴⁶ See *supra* note 201 at 51.

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APPENDIX ONE:

Third Protocol⁶⁴⁷

Amending the Convention between Canada and the United States of America with respect to taxes on Income and on Capital signed at Washington on September 26, 1980, as amended by the Protocols signed on June 14, 1983, and March 28, 1984.

Canada and the United States of America, desiring to conclude a Protocol to amend the Convention with Respect to Taxes on Income and on Capital signed at Washington on September 26, 1980, as amended by the Protocols signed on June 14, 1983, and March 28, 1984 (hereinafter referred to as "the Convention") have agreed as follows:

Article 1: Taxes Covered

1. Paragraphs 2 to 4 of Article II (Taxes Covered) of the Convention shall be deleted and replaced by the following:

“2. Notwithstanding paragraph 1, the taxes existing on March 17, 1995 to which the Convention shall apply are:

(a) in the case of Canada, the taxes imposed by the Government of Canada under the Income Tax Act; and

(b) in the case of the United States, the Federal income taxes imposed by the Internal Revenue Code of 1986. However, the Convention shall apply to:

(i) the United States accumulated earnings tax and personal holding company tax, to the extent, and only to the extent, necessary to implement the provisions of paragraphs 5 and 8 of Article X (Dividends);

(ii) the United States excise taxes imposed with respect to private foundations, to the extent, and only to the extent, necessary to implement the provisions of paragraph 4 of Article XXI (Exempt Organizations);

⁶⁴⁷ On March 17, 1995, a revised Protocol amending the Treaty Between Canada and the United States with respect to taxes on income and on capital signed on September 26, 1980, as amended by the Protocols signed on June 14, 1983 and March 28, 1984, was signed. The revised Protocol is essentially the same as the August 31, 1995, Protocol. The revised Protocol merely recognizes that the Protocol has not yet been ratified and it accordingly includes revised dates as to effectiveness of the Protocol. Department of Finance Press Release, March 17, 1995.

(iii) the United States social security taxes, to the extent, and only to the extent, necessary to implement the provisions of paragraph 2 of Article XXIV (Elimination of Double Taxation) and paragraph 4 of Article XXIX (Miscellaneous Rules); and

(iv) the United States estate taxes imposed by the Internal Revenue Code of 1986, to the extent, and only to the extent, necessary to implement the provisions of paragraph 3(g) of Article XXVI (Mutual Agreement Procedure) and Article XXIX B (Taxes Imposed by Reason of Death).

3. The Convention shall apply also to:

(a) any taxes identical or substantially similar to those taxes to which the Convention applies under paragraph 2; and

(b) taxes on capital;

which are imposed after March 17, 1995 in addition to , or in place of, the taxes to which the Convention applies under paragraph 2.”

Article 2: General Definitions

Subparagraphs (c) and (d) of paragraph 1 of Article III (General Definitions) of the Convention shall be deleted and replaced by the following:

“(c) the term ‘Canadian tax’ means the taxes referred to in Article II (Taxes Covered) that are imposed on income by Canada;

(d) the term ‘United States tax’ means the taxes referred to in Article II (Taxes Covered), other than in subparagraph (b)(i) to (iv) of paragraph 2 thereof, that are imposed on income by the United States;”

Article 3: Residence

1. Paragraph 1 of Article IV (Residence) of the Convention shall be deleted and replaced by the following:

“1. For the purposes of this Convention, the term ‘resident’ of a Contracting State means any person that, under the laws of that State, is liable to tax therein by reason of that person's domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature, but in the case of an estate or trust, only to the extent that income derived by the estate or trust is liable to tax in that State, either in its hands or in the hands of its beneficiaries. For the purposes of this paragraph, an individual who is not a resident of Canada under this paragraph and who is a United States citizen or an alien admitted to the United States for permanent residence (a ‘green card’ holder)

is a resident of the United States only if the individual has a substantial presence, permanent home or habitual abode in the United States, and that individual's personal and economic relations are closer to the United States than to any third State. The term "resident" of a Contracting State is understood to include:

(a) the Government of that State or a political subdivision or local authority thereof or any agency or instrumentality of any such government, subdivision or authority, and

(b)(i) a trust, organization or other arrangement that is operated exclusively to administer or provide pension, retirement or employee benefits; and

(ii) a not-for-profit organization

that was constituted in that State and that is, by reason of its nature as such, generally exempt from income taxation in that State."

2. A new sentence shall be added at the end of paragraph 3 of Article IV (Residence) of the Convention as follows:

"Notwithstanding the preceding sentence, a company that was created in a Contracting State, that is a resident of both Contracting States and that is continued at any time in the other Contracting State in accordance with the corporate law in that other State shall be deemed while it is so continued to be a resident of that other State.

Article 4: Related Persons

Paragraphs 3 and 4 of Article IX (Related Persons) of the Convention shall be deleted and replaced by the following:

"3. Where an adjustment is made or to be made by a Contracting State in accordance with paragraph 1, the other Contracting State shall (notwithstanding any time or procedural limitations in the domestic law of that other State) make a corresponding adjustment to the income, loss or tax of the related person in that other State if:

(a) it agrees with the first-mentioned adjustment; and

(b) within six years from the end of the taxable year to which the first-mentioned adjustment relates, the competent authority of the other State has been notified of the first-mentioned adjustment. The competent authorities, however, may agree to consider cases where the corresponding adjustment would not otherwise be barred by any time or procedural limitations in the other State, even if the notification is not made within the six-year period.

4. In the event that the notification referred to in paragraph 3 is not given within the time period referred to therein, and the competent authorities have not agreed to otherwise consider the case in accordance with paragraph 3(b), the competent authority of the Contracting State which has made or is to make the first-mentioned adjustment may provide relief from double taxation where appropriate.”

Article 5: Dividends

1. The reference in paragraphs 2(a) and 6 of Article X (Dividends) of the Convention to a rate of tax of “10 per cent” shall be deleted and replaced by references to a rate of tax of “5 per cent”.

2. Paragraph 7 of Article X (Dividends) of the Convention shall be deleted and replaced by the following:

“7. Notwithstanding the provisions of paragraph 2,

(a) dividends paid by a company that is a resident of Canada and a non-resident-owned investment corporation to a company that is a resident of the United States, that owns at least 10 per cent of the voting stock of the company paying the dividends and that is the beneficial owner of such dividends, may be taxed in Canada at a rate not exceeding 10 per cent of the gross amount of the dividends;

(b) paragraph 2(b) and not paragraph 2(a) shall apply in the case of dividends paid by a resident of the United States that is a Regulated Investment Company; and

(c) Paragraph 2(a) shall not apply to dividends paid by a resident of the United States that is a Real Estate Investment Trust, and paragraph 2(b) shall apply only where such dividends are beneficially owned by an individual holding an interest of less than 10 per cent in the trust; otherwise the rate of tax applicable under the domestic law of the United States shall apply. Where an estate or a testamentary trust acquired its interest in a Real Estate Investment Trust as a consequence of an individual's death, for the purposes of the preceding sentence the estate or trust shall for the five-year period following the death be deemed with respect to that interest to be an individual.”

Article 6: Interest

1. The reference in paragraph 2 of Article XI (Interest) of the Convention to “15 per cent” shall be deleted and replaced by a reference to “10 per cent”.

2. Paragraph 3(d) of Article XI (Interest) of the Convention shall be deleted and replaced by the following:

“(d) the interest is beneficially owned by a resident of the other Contracting State and is paid with respect to indebtedness arising as a consequence of the sale on credit by a resident of that other State of any equipment, merchandise or services except where the sale or indebtedness was between related persons; or”

3. A new paragraph 9 shall be added to Article XI (Interest) of the Convention as follows:

“9. The provisions of paragraphs 2 and 3 shall not apply to an excess inclusion with respect to a residual interest in a Real Estate Mortgage Investment Conduit to which Section 860G of the United States Internal Revenue Code, as it may be amended from time to time without changing the general principle thereof, applies.”

Article 7: Royalties

1. Paragraph 3 of Article XII (Royalties) of the Convention shall be declared and replaced by the following:

“3. Notwithstanding the provisions of paragraph 2,

(a) copyright royalties and other like payments in respect of the production or reproduction of any literary, dramatic, musical or artistic work (other than payments in respect of motion pictures and works on film, videotape or other means of reproduction for use in connection with television);

(b) payments for the use of, or the right to use, computer software;

(c) payments for the use of, or the right to use, any patent or any information concerning industrial, commercial or scientific experience (but not including any such information provided in connection with a rental or franchise agreement); and

(d) payments with respect to broadcasting as may be agreed for the purposes of this paragraph in an exchange of notes between the Contracting States;

arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.”

2. Paragraph 6 of Article XII (Royalties) of the Convention shall be deleted and replaced by the following:

“6. For the purposes of this Article,

(a) royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a State a permanent establishment or a fixed base in connection with which the obligation to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated and not in any other State of which the payer is a resident; and

(b) where subparagraph (a) does not operate to treat royalties as arising in either Contracting State and the royalties are for the use of, or the right to use, intangible property or tangible personal property in a Contracting State, then such royalties shall be deemed to arise in that State.”

Article 8: Gains

Paragraph 8 of Article XIII (Gains) of the Convention shall be deleted and replaced by the following:

“8. Where a resident of a Contracting State alienates property in the course of a corporate or other organization, reorganization, amalgamation, division or similar transaction and profit, gain or income with respect to such alienation is not recognized for the purpose of taxation in that State, if requested to do so by the person who acquires the property, the competent authority of the other Contracting State may agree, in order to avoid double taxation and subject to terms and conditions satisfactory to such competent authority, to defer the recognition of the profit, gain or income with respect to such property for the purpose of taxation in that other State until such time and in such manner as may be stipulated in the agreement.”

Article 9: Pensions and Annuities

1. Paragraph 3 of Article XVIII (Pensions and Annuities) of the Convention shall be deleted and replaced by the following:

“3. For the purposes of this Convention, the term ‘pensions’ includes any payment under a superannuation, pension or other retirement arrangement, Armed Forces retirement pay, war veterans pensions and allowances and amounts paid under a sickness, accident or disability plan, but does not include payments under an income-averaging annuity contract or any benefit referred to in paragraph 5.”

2. Paragraph 5 of Article XVIII (Pensions and Annuities) of the Convention shall be deleted and replaced by the following:

“5. Benefits under the social security legislation in a Contracting State (including tier 1 railroad benefits but not including unemployment benefits) paid to a resident of the other Contracting State (and in the case of Canadian benefits, to a citizen of the United States) shall be taxable only in the first-mentioned State.”

3. A new paragraph 7 shall be added to Article XVIII (Pensions and Annuities) of the Convention as follows:

“7. A natural person who is a citizen or resident of a Contracting State and a beneficiary of a trust, company, organization or other arrangement that is a resident of the other Contracting State, generally exempt from income taxation in that other State and operated exclusively to provide pension, retirement or employee benefits may elect to defer taxation in the first-mentioned State, under rules established by the competent authority of that State, with respect to any income accrued in the plan but not distributed by the plan, until such time as and to the extent that a distribution is made from the plan or any plan substituted therefor.

Article 10: Exempt Organizations

1. Paragraphs 2 and 3 of Article XXI (Exempt Organizations) of the Convention shall be deleted and replaced by the following:

“2. Subject to the provisions of paragraph 3, income referred to in Articles X (Dividends) and XI (Interest) derived by:

(a) a trust, company, organization or other arrangement that is a resident of a Contracting State, generally exempt from income taxation in a taxable year in that State and operated exclusively to administer or provide pension, retirement or employee benefits; or

(b) a trust, company, organization or other arrangement that is a resident of a Contracting State, generally exempt from income taxation in a taxable year in that State and operated exclusively to earn income for the benefit of an organization referred to in subparagraph (a);

shall be exempt from income taxation in that taxable year in the other Contracting State.

3. The provisions of paragraphs 1 and 2 shall not apply with respect to the income of a trust, company, organization or other arrangement from carrying on a trade or business or from a related person other than a person referred to in paragraph 1 or 2.”

2. A new sentence shall be added at the end of paragraph 5 of Article XXI (Exempt Organizations) of the Convention as follows:

“for the purposes of this paragraph, a company that is a resident of Canada and that is taxable in the United States as if it were a resident of the United States shall be deemed to be a resident of the United States.”

3. Paragraph 6 of Article XXI (Exempt Organizations) of the Convention shall be deleted and replaced by the following:

“6. For the purposes of Canadian taxation, gifts by a resident of Canada to an organization that is a resident of the United States, that is generally exempt from United States tax and that could qualify in Canada as a registered charity if it were a resident of Canada and created or established in Canada, shall be treated as gifts to a registered charity; however, no relief from taxation shall be available in any taxation year with respect to such gifts (other than such gifts to a college or university at which the resident or a member of the resident's family is or was enrolled) to the extent that such relief would exceed the amount of relief that would be available under the Income Tax Act if the only income of the resident for that year were the resident's income arising in the United States. The preceding sentence shall not be interpreted to allow in any taxation year relief from taxation for gifts to registered charities in excess of the amount of relief allowed under the percentage limitations of the laws of Canada in respect of relief for gifts to registered charities.”

Article 11: Other Income

A new paragraph 3 shall be added to Article XXII(Other Income) of the Convention as follows:

“3. Losses incurred by a resident of a Contracting State with respect to wagering transactions the gains on which may be taxed in the other Contracting State shall, for the purpose of taxation in that other State, be deductible to the same extent that such losses would be deductible if they were incurred by a resident of that other State.”

Article 12: Elimination of Double Taxation

1. Paragraphs 2(a) and 2(b) of Article XXIV (Elimination of Double Taxation) of the Convention shall be deleted and replaced by the following:

“(a) subject to the provisions of the law of Canada regarding the deduction from tax payable in Canada of tax paid in a territory outside Canada and to any subsequent modification of those provisions (which shall not affect the general principle hereof)

(i) income tax paid or accrued to the United States on profits, income or gains arising in the United States, and

(ii) in the case of an individual, any social security taxes paid to the United States (other than taxes relating to unemployment insurance benefits) by the individual on such profits, income or gains shall be deducted from any Canadian tax payable in respect of such profits, income or gains;

(b) subject to the existing provisions of the law of Canada regarding the taxation of income from a foreign affiliate and to any subsequent modification of those provisions—which shall not affect the general principle hereof—for the purpose of computing Canadian tax, a company which is a resident of Canada shall be allowed to deduct in computing its taxable income any dividend received by it out of the exempt surplus of a foreign affiliate which is a resident of the United States; and”

2. Paragraph 5 of Article XXIV (Elimination of Double Taxation) of the Convention shall be deleted and replaced by the following:

“5. Notwithstanding the provisions of paragraph 4, where a United States citizen is a resident of Canada, the following rules shall apply in respect of the items of income referred to in Article X (Dividends), XI (Interest) or XII (Royalties) that arise (within the meaning of paragraph 3) in the United States and that would be subject to United States tax if the resident of Canada were not a citizen of the United States, as long as the law in force in Canada allows a deduction in computing income for the portion of any foreign tax paid in respect of such items which exceeds 15 per cent of the amount thereof:

(a) the deduction so allowed in Canada shall not be reduced by any credit or deduction for income tax paid or accrued to Canada allowed in computing the United States tax on such items;

(b) Canada shall allow a deduction from Canadian tax on such items in respect of income tax paid or accrued to the United States on such items, except that such deduction need not exceed the amount of the tax that would be paid on such items to the United States if the resident of Canada were not a United States citizen; and

(c) for the purposes of computing the United States tax on such items, the United States shall allow as a credit against United States tax the income tax paid or accrued to Canada after the deduction referred to in subparagraph (b). The credit so allowed shall reduce only that portion of the United States tax on such items which exceeds the amount of tax that would be paid to the United States on such items if the resident of Canada were not a United States citizen.”

3. Paragraph 7 of Article XXIV (Elimination of Double Taxation) of the Convention shall be deleted and replaced by the following:

“7. For the purposes of this Article, any reference to ‘income tax paid or accrued’ to a Contracting State shall include Canadian tax and United States tax, as the case may be, and taxes of general application which are paid or accrued to a political subdivision or local authority of that State, which are not imposed by that political subdivision or local authority in a manner inconsistent with the provisions of the Convention and which are substantially similar to the Canadian tax or United States tax, as the case may be.”

4. A new paragraph 10 shall be added to Article XXIV (Elimination of Double Taxation) of the Convention as follows:

“10. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on other income or capital, take into account the exempted income or capital.”

Article 13: Non-Discrimination

1. Paragraph 3 of Article XXV (Non-Discrimination) of the Convention shall be deleted and replaced by the following:

“3. In determining the taxable income or tax payable of an individual who is a resident of a Contracting State, there shall be allowed as a deduction in respect of any other person who is a resident of the other Contracting State and who is dependent on the individual for support the amount that would be so allowed if that other person were a resident of the first-mentioned State.”

2. Paragraph 10 of Article XXV (Non-Discrimination) of the Convention shall be deleted and replaced by the following:

“10. Notwithstanding the provisions of Article II (Taxes Covered), this Article shall apply to all taxes imposed by a Contracting State.”

Article 14: Mutual Agreement Procedure

1. Paragraphs 3(f) and (g) of Article XXVI (Mutual Agreement Procedure) of the Convention shall be deleted and replaced by the following:

“(f) to the elimination of double taxation with respect to a partnership;

(g) to provide relief from double taxation resulting from the application of the estate tax imposed by the United States or the Canadian tax as a result of a distribution or disposition of property by a trust that is a qualified domestic trust within the meaning of section 2056A of the Internal Revenue Code, or is described in subsection 70(6) of the Income Tax Act

or is treated as such under paragraph 5 of Article XXIX B (Taxes Imposed by Reason of Death), in cases where no relief is otherwise available; or

(h) to increases in any dollar amounts referred to in the Convention to reflect monetary or economic developments.”

2. A new paragraph 6 shall be added to Article XXIV (Mutual Agreement Procedure) of the Convention as follows:

“6. If any difficulty or doubt arising as to the interpretation or application of the Convention cannot be resolved by the competent authorities pursuant to the preceding paragraphs of this Article, the case may, if both competent authorities and the taxpayer agree, be submitted for arbitration, provided that the taxpayer agrees in writing to be bound by the decision of the arbitration board. The decision of the arbitration board in a particular case shall be binding on both States with respect to that case. The procedures shall be established in an exchange of notes between the Contracting States. The provisions of this paragraph shall have effect after the Contracting States have so agreed through the exchange of notes.”

Article 15: Assistance in Collection

A new Article XXVI A (Assistance in Collection) shall be added to the Convention as follows:

“Article XXVI A

Assistance in Collection

1. The Contracting States undertake to lend assistance to each other in the collection of taxes referred to in paragraph 9, together with interest, costs, additions to such taxes and civil penalties, referred to in this Article as a “revenue claim”.

2. An application for assistance in the collection of a revenue claim shall include a certification by the competent authority of the applicant State that, under the laws of that State, the revenue claim has been finally determined. For the purposes of this Article, a revenue claim is finally determined when the applicant State has the right under its internal law to collect the revenue claim and all administrative and judicial rights of the taxpayer to restrain collection in the applicant State have lapsed or been exhausted.

3. A revenue claim of the applicant State that has been finally determined may be accepted for collection by the competent authority of the requested State and, subject to the provisions of paragraph 7, if accepted shall be collected by the requested State as though such revenue claim were the requested State's own revenue claim finally determined in accordance with the laws applicable to the collection of the requested State's own taxes.

4. Where an application for collection of a revenue claim in respect of a taxpayer is accepted

(a) by the United States, the revenue claim shall be treated by the United States as an assessment under United States laws against the taxpayer as of the time the application is received; and

(b) by Canada, the revenue claim shall be treated by Canada as an amount payable under the Income Tax Act, the collection of which is not subject to any restriction.

5. Nothing in this Article shall be construed as creating or providing any rights of administrative or judicial review of the applicant State's finally determined revenue claim by the requested State, based on any such rights that may be available under the laws of either Contracting State. If, at any time pending execution of a request for assistance under this Article, the applicant State loses the right under its internal law to collect the revenue claim, the competent authority of the applicant State shall promptly withdraw the request for assistance in collection.

6. Subject to this paragraph, amounts collected by the requested State pursuant to this Article shall be forwarded to the competent authority of the applicant State. Unless the competent authorities of the Contracting States otherwise agree, the ordinary costs incurred in providing collection assistance shall be borne by the requested State and any extraordinary costs so incurred shall be borne by the applicant State.

7. A revenue claim of an applicant State accepted for collection shall not have in the requested State any priority accorded to the revenue claims of the requested State.

8. No assistance shall be provided under this Article for a revenue claim in respect of a taxpayer to the extent that the taxpayer can demonstrate that

(a) where the taxpayer is an individual, the revenue claim relates to a taxable period in which the taxpayer was a citizen of the requested State, and

(b) where the taxpayer is an entity that is a company, estate or trust, the revenue claim relates to a taxable period in which the taxpayer derived its status as such an entity from the laws in force in the requested State.

9. Notwithstanding the provisions of Article II (Taxes Covered), the provisions of this Article shall apply to all categories of taxes collected by or on behalf of the Government of a Contracting State.

10. Nothing in this Article shall be construed as:

(a) limiting the assistance provided for in paragraph 4 of Article XXVI (Mutual Agreement Procedure); or

(b) imposing on either Contracting State the obligation to carry out administrative measures of a different nature from those used in the collection of its own taxes or that would be contrary to its public policy (order public).

11. The competent authorities of the Contracting States shall agree upon the mode of application of this Article, including agreement to ensure comparable levels of assistance to each of the Contracting States."

Article 16: Exchange of Information

1. Paragraph 1 of Article XXVII (Exchange of Information) of the Convention shall be deleted and replaced by the following:

“1. The competent authorities of the Contracting States shall exchange such information as is relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes to which the Convention applies insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article I (Personal Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the taxation laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the administration and enforcement in respect of, or the determination of appeals in relation to the taxes to which the Convention applies or, notwithstanding paragraph 4, in relation to taxes imposed by a political subdivision or local authority of a Contracting State that are substantially similar to the taxes covered by the Convention under Article II (Taxes Covered). Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. The competent authorities may release to an arbitration board established pursuant to paragraph 6 of Article XXVI (Mutual Agreement Procedure) such information as is necessary for carrying out the arbitration procedure; the members of the arbitration board shall be subject to the limitations on disclosure described in this Article.

2. Paragraph 4 of Article XXVII (Exchange of Information) of the Convention shall be deleted and replaced by the following:

“4. For the purposes of this Article, the Convention shall apply, notwithstanding the provisions of Article II (Taxes Covered):

(a) to all taxes imposed by a Contracting State; and

(b) to other taxes to which any other provision of the Convention applies, but only to the extent that the information is relevant for the purposes of the application of that provision.

Article 17: Miscellaneous Rules

1. Paragraph 3(a) of Article XXIX (Miscellaneous Rules) of the Convention shall be deleted and replaced by the following:

“(a) under paragraphs 3 and 4 of Article IX (Related Persons), paragraphs 6 and 7 of Article XIII (Gains), paragraphs 1, 3, 4, 5, 6(b) and 7 of Article XVIII (Pensions and Annuities), paragraph 5 of Article XXIX (Miscellaneous Rules), paragraphs 1, 5 and 6 of Article XXIX B (Taxes Imposed by Reason of Death),

paragraphs 2, 3 4 and 7 of Article XXIX B (Taxes Imposed by Reason of Death) as applied to the estates of persons other than former citizens referred to in paragraph 2 of this Article, paragraphs 3 and 5 of Article XXX (Entry into Force), and Articles XIX (Government Service), XXI (Exempt Organizations), XXIV (Elimination of Double Taxation), XXV (Non-Discrimination) and XXVI (Mutual Agreement Procedure);”

2. Paragraph 5 to 7 of Article XXIX (Miscellaneous Rules) of the Convention shall deleted and replaced by the following:

“5. Where a person who is a resident of Canada and a shareholder of a United States S corporation requests the competent authority of Canada to do so, the competent authority may agree, subject to terms and conditions satisfactory to such competent authority, to apply the following rules for the purposes of taxation in Canada with respect to the period during which the agreement is effective:

- (a) the corporation shall be deemed to be a controlled foreign affiliate of the person;
- (b) all the income of the corporation shall be deemed to be foreign accrual property income;
- (c) for the purposes of subsection 20(11) of the Income Tax Act, the amount of the corporation's income that is included in the person's income shall be deemed not to be income from a property; and
- (d) each dividend paid to the person on a share of the capital stock of the corporation shall be excluded from the person's income and shall be deducted in computing the adjusted cost base to the person of the share.

6. For purposes of paragraph 3 of Article XXII (Consultation) of the General Agreement on Trade in Services, the Contracting States agree that:

- (a) a measure falls within the scope of the Convention only if:
 - (i) the measure relates to a tax to which Article XXV (Non-Discrimination) of the Convention applies; or
 - (ii) the measure relates to a tax to which Article XXV (Non-Discrimination) of the Convention does not apply and to which any other provision of the Convention applies, but only to the extent that the measure relates to a matter dealt with in that other provision of the Convention; and
- (b) notwithstanding paragraph 3 of Article XXII (Consultation) of the General Agreement on Trade in Services, any doubt as to the interpretation of subparagraph (a) will be resolved under paragraph 3 of Article XXVI (Mutual Agreement Procedure) of the Convention or any other procedure agreed to by both Contracting States.

7. The appropriate authority of a Contracting State may request consultations with the appropriate authority of the other Contracting State to

determine whether change to the Convention is appropriate to respond to changes in the law or policy of that other State. Where domestic legislation enacted by a Contracting State unilaterally removes or significantly limits any material benefit otherwise provided by the Convention, the appropriate authorities shall promptly consult for the purpose of considering an appropriate change to the Convention.”

Article 18: Limitation on Benefits

A new Article XXIX A (Limitation on Benefits) shall be added to the Convention as follows:

“Article XXIX A

Limitation on Benefits

1. For the purposes of the application of this Convention by the United States,
 - (a) a qualifying person shall be entitled to all of the benefits of this Convention, and
 - (b) except as provided in paragraphs 3, 4 and 6, a person that is not a qualifying person shall not be entitled to any benefits of the Convention.
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 per cent of the vote 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 per cent or more of the vote 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 per cent or more of the beneficial interest in which is not owned, directly or indirectly, by persons other than qualifying persons or residents or citizens of the United States,

where the amount of the expenses deductible from 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 per cent 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.

3. Where a person that is a resident of Canada and is not a qualifying person of Canada, 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 United States in connection with or incidental to that trade or business, including any such income derived directly or indirectly by that resident person through one or more other persons that are residents of the United States. 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 United States giving rise to the income in respect of which benefits provided under the Convention by the United States are claimed.

4. A company that is a resident of Canada shall also be entitled to the benefits of Articles X (Dividends), XI (Interest) and XII (Royalties) if

(a) its shares that represent more than 90 per cent of the aggregate vote and value represented by all of its shares (other than debt substitute shares) are owned, directly or indirectly, by persons each of whom is a qualifying person, a resident or citizen of the United States or a person who

(i) is a resident of a country with which the United States has a comprehensive income tax Convention and is entitled to all of the benefits provided by the United States under that Convention;

(ii) would qualify for benefits under paragraphs 2 or 3 if that person were a resident of Canada (and, for the purposes of paragraph 3, if the business it carried on in the country of which it is a resident were carried on by it in Canada); and

(iii) would be entitled to a rate of United States tax under the Convention between that person's country of residence and the United States, in respect of the particular class of income for which benefits are being claimed under this Convention, that is at least as low as the rate applicable under this Convention; and

(b) the amount of the expenses deductible from gross income that are paid or payable by the company 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 per cent of the gross income of the company for that period.

5. For the purposes of this Article,

(a) the term "recognized stock exchange" means:

(i) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934;

(ii) Canadian stock exchanges that are "prescribed stock exchanges" under the Income Tax Act; and

(iii) any other stock exchange agreed upon by the Contracting States in an exchange of notes or by the competent authorities of the Contracting States;

(b) the term "not-for-profit organization" of a Contracting State means an entity created or established in that State and that is, by reason of its not-for-profit status, generally exempt from income taxation in that State, and includes a private foundation, charity, trade union, trade association or similar organization; and

(c) the term "debt substitute share" means:

(i) a share described in paragraph (e) of the definition "term preferred share" in the Income Tax Act, as it may be amended from time to time without changing the general principle thereof; and

(ii) such other type of share as may be agreed upon by the competent authorities of the Contracting States.

6. Where a person that is a resident of Canada is not entitled under the preceding provisions of this Article to the benefits provided under the Convention by the United States, the competent authority of the United States shall, upon that

person's request, determine on the basis of all 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.

7. It is understood that the fact that the preceding provisions of this Article apply only for the purposes of the application of the Convention by the United States shall not be construed as restricting in any manner the right of a Contracting State 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."

Article 19: Taxes Imposed by Reason of Death

A new Article XXIX B (Taxes Imposed by Reason of Death) shall be added to the Convention as follows:

"Article XXIX B

Taxes Imposed by Reason of Death

1. Where the property of an individual who is a resident of a Contracting State passes by reason of the individual's death to an organization referred to in paragraph 1 of Article XXI (Exempt Organizations), the tax consequences in a Contracting State arising out of the passing of the property shall apply as if the organization were a resident of that State.

2. In determining the estate tax imposed by the United States, the estate of an individual (other than a citizen of the United States) who was a resident of Canada at the time of the individual's death shall be allowed a unified credit equal to the greater of

(a) the amount that bears the same ratio to the credit allowed under the law of the United States to the estate of a citizen of the United States as the value of the part of the individual's gross estate that at the time of the individual's death is situated in the United States bears to the value of the individual's entire gross estate wherever situated; and

(b) the unified credit allowed to the estate of a non-resident not a citizen of the United States under the law of the United States.

The amount of any unified credit otherwise allowable under this paragraph shall be reduced by the amount of any credit previously allowed with respect to any gift made by

the individual. The credit otherwise allowable under subparagraph (a) shall be allowed only if all information necessary for the verification and computation of the credit is provided.

3. In determining the estate tax imposed by the United States on an individual's estate with respect to property that passes to the surviving spouse of the individual (within the meaning of the law of the United States) and that would qualify for the estate tax marital deduction under the law of the United States if the surviving spouse were a citizen of the United States and all applicable elections were properly made (in this paragraph and in paragraph 4 referred to as "qualifying property"), a non-refundable credit computed in accordance with the provisions of paragraph 4 shall be allowed in addition to the unified credit allowed to the estate under paragraph 2 or under the law of the United States, provided that

- (a) the individual was at the time of death a citizen of the United States or a resident of either Contracting State;
- (b) the surviving spouse was at the time of the individual's death a resident of either Contracting State;
- (c) if both the individual and the surviving spouse were residents of the United States at the time of the individual's death, one or both was a citizen of Canada; and
- (d) the executor of the decedent's estate elects the benefits of this paragraph and waives irrevocably the benefits of any estate tax marital deduction that would be allowed under the law of the United States on a United States Federal estate tax return filed for the individual's estate by the date on which a qualified domestic trust election could be made under the law of the United States.

4. The amount of the credit allowed under paragraph 3 shall equal the lesser of

- (a) the unified credit allowed under paragraph 2 or under the law of the United States (determined without regard to any credit allowed previously with respect to any gift made by the individual), and
- (b) the amount of estate tax that would otherwise be imposed by the United States on the transfer of qualifying property.

The amount of estate tax that would otherwise be imposed by the United States on the transfer of qualifying property shall equal the amount by which the estate tax (before allowable credits) that would be imposed by the United States of the qualifying property were included in computing the taxable estate exceeds the estate tax (before allowable credits) that would be so imposed if the qualifying property were not so included. Solely for purposes of determining other credits allowed under the law of the United State, the credit provided under paragraph 3 shall be allowed after such other credits.

5. Where an individual was a resident of the United States immediately before the individual's death, for the purposes of subsection 70(6) of the Income Tax Act, both the individual and the individual's spouse shall be deemed to have been resident in Canada

immediately before the individual's death. Where a trust that would be a trust described in subsection 70(6) of that Act, if its trustees that were residents or citizens of the United States or domestic corporations under the law of the United States were residents of Canada, requests the competent authority of Canada to do so, the competent authority may agree, subject to terms and conditions satisfactory to such competent authority, to treat the trust for the purposes of that Act as being resident in Canada for such time as may be stipulated in the agreement.

6. In determining the amount of Canadian tax payable by an individual who immediately before death was a resident of Canada, or by a trust described in subsection 70(6) of the Income Tax Act (or a trust which is treated as being resident in Canada under the provisions of paragraph 5), the amount of any Federal or state estate or inheritance taxes payable in the United States (not exceeding, where the individual was a citizen of the United States or a former citizen referred to in paragraph 2 of Article XXIX (Miscellaneous Rules), the amount of estate and inheritance taxes that would have been payable if the individual were not a citizen or former citizen of the United States) in respect of property situated within the United States shall,

(a) to the extent that such estate or inheritance taxes are imposed upon the individual's death, be allowed as a deduction from the amount of any Canadian tax otherwise payable by the individual for the taxation year in which the individual died on the total of

(i) any income, profits or gains of the individual arising (within the meaning of paragraph 3 of Article XXIV (Elimination of Double Taxation)) in the United States in that year, and

(ii) where the value at the time of the individual's death of the individual's entire gross estate wherever situated (determined under the law of the United States) exceeded 1.2 million U.S. dollars or its equivalent in Canadian dollars, any income, profits or gains of the individual for that year from property situated in the United States at that time, and

(b) to the extent that such estate or inheritance taxes are imposed upon the death of the individual's surviving spouse, be allowed as a deduction from the amount of any Canadian tax otherwise payable by the trust for its taxation year in which that spouse dies on any income, profits or gains of the trust for that year arising (within the meaning of paragraph 3 of Article XXIV (Elimination of Double Taxation)) in the United States or from property situated in the United States at the time of death of the spouse.

For purposes of this paragraph, property shall be treated as situated within the United States if it is so treated for estate tax purposes under the law of the United States as in effect on March 17, 1995, subject to any subsequent changes thereof that the competent authorities of the Contracting States have agreed to apply for the purposes of this paragraph. The deduction allowed under this paragraph shall take into account the deduction for any income tax paid or accrued to the United States that is provided under paragraph 2(a), 4(a) or 5(b) of Article XXIV (Elimination of Double Taxation).

7. In determining the amount of estate tax imposed by the United States on the estate of an individual who was a resident or citizen of the United States at the time of death, or upon the death of a surviving spouse with respect to a qualified domestic trust created by such an individual or the individual's executor or surviving spouse, a credit shall be allowed against such tax imposed in respect of property situated outside the United States, for the federal and provincial income taxes payable in Canada in respect of such property by reason of the death of the individual or, in the case of a qualified domestic trust, the individual's surviving spouse. Such credit shall be computed in accordance with the following rules:

- (a) a credit otherwise allowable under this paragraph shall be allowed regardless of whether the identity of the taxpayer under the law of Canada corresponds to that under the law of the United States;
- (b) the amount of a credit allowed under this paragraph shall be computed in accordance with the provisions and subject to the limitations of the law of the United States regarding credit for foreign death taxes (as it may be amended from time to time without changing the general principle hereof), as though the income tax imposed by Canada were a creditable tax under that law;
- (c) a credit may be claimed under this paragraph for an amount of federal or provincial income tax payable in Canada only to the extent that no credit or deduction is claimed for such amount in determining any other tax imposed by the United States, other than the estate tax imposed on property in a qualified domestic trust upon the death of the surviving spouse.

8. Provided that the value, at the time of death, of the entire gross estate wherever situated of an individual who was a resident of Canada (other than a citizen of the United States) at the time of death does not exceed 1.2 million U.S. dollars or its equivalent in Canadian dollars, the United States may impose its estate tax upon property forming part of the estate of the individual only if any gain derived by the individual from the alienation of such property would have been subject to income taxation by the United States in accordance with Article XIII (Gains)."

Article 20: Future Consultation

1. The appropriate authorities of the Contracting States shall consult within a three-year period from the date on which this Protocol enters into force with respect to further reductions in withholding taxes provided in the Convention, and with respect to the rules in Article XXIX A (Limitation on Benefits) of the Convention.

2. The appropriate authorities of the Contracting States shall consult after a three-year period from the date on which the Protocol enters into force in order to determine whether it is appropriate to make the exchange of notes referred to in Article XXVI (Mutual Agreement Procedure) of the Convention.

Article 21: Entry into Force

1. This Protocol shall be subject to ratification in accordance with the applicable procedures in Canada and the United States and instruments of ratification shall be exchanged as soon as possible.

2. The Protocol shall enter into force upon the exchange of instruments of ratification, and shall have effect:

(a) For tax withheld at the source on income referred to in Articles X (Dividends), XI (Interest), XII (Royalties) and XVIII (Pensions and Annuities) of the Convention, except on income referred to in paragraph 5 of Article XVIII of the Convention (as it read before the entry into force of this Protocol), with respect to amounts paid or credited on or after the first day of the second month next following the date on which the Protocol enters into force, except that the reference in paragraph 2(a) of Article X (Dividends) of the Convention, as amended by the Protocol, to "5 per cent" shall be read, in its application to amounts paid or credited on or after that first day:

(i) Before 1996, as "7 per cent"; and

(ii) After 1995 and before 1997, as "6 per cent", and

(b) For other taxes, with respect to taxable years beginning on or after the first day of January next following the date on which the Protocol enters into force, except that the reference in paragraph 6 of Article X (Dividends) of the Convention, as amended by the Protocol, to "5 per cent" shall be read, in its application to taxable years beginning on or after that first day and ending before 1997, as "6 per cent".

3. Notwithstanding the provisions of paragraph 2, Article XXVI A (Assistance in Collection) of the Convention shall have effect for revenue claims finally determined by a requesting State after the date that is 10 years before the date on which the Protocol enters into force.

4. Notwithstanding the provisions of paragraph 2, paragraphs 2 through 8 of Article XXIX B (Taxes Imposed by Reason of Death) of the Convention (and paragraph 2 of Article II (Taxes Covered) and paragraph 3(a) of Article XXIX (Miscellaneous Rules) of the Convention, as amended by the Protocol, to the extent necessary to implement paragraphs 2 through 8 of Article XXIX B (Taxes Imposed by Reason of Death) of the Convention) shall, notwithstanding any limitation imposed under the law of a Contracting State on the assessment, reassessment or refund with respect to a person's return, have effect with respect to deaths occurring after the date on which the Protocol enters into force and, provided that any claim for refund by reason of this sentence is filed within one year of the date on which the Protocol enters into force or within the otherwise applicable period for filing such claims under domestic law, with respect to benefits provided under any of those paragraphs with respect to deaths occurring after November 10, 1988.

5. Notwithstanding the provisions of paragraph 2, paragraph 2 of Article 3 of the Protocol shall have effect with respect to taxable years beginning on or after the first day of January next following the date on which the Protocol enters into force.

APPENDIX TWO:

Article 16 of the 1981 U.S. Model Income Tax Treaty.⁶⁴⁸

1. A person (other than an individual) which is a resident of a contracting state shall not be entitled under this convention to relief from taxation in the other contracting state unless:

- (a) more than seventy-five percent of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned contracting state; and
- (b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a state other than a contracting state and who are not citizens of the United States.

For purposes of subparagraph (a), a company that has substantial trading in its stock on a recognized exchange in a contracting state is presumed to be owned by individual residents of that contracting state.

2. Paragraph 1 shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operation did not have as its principal purpose obtaining benefits under the convention.

3. Any relief from tax provided by a contracting state to a resident of the other contracting state under the convention shall be inapplicable to the extent that, under the law in force in that other state, the income to which the relief relates bears significantly lower tax than similar income arising within that other state derived by residents of that other state.

⁶⁴⁸ Article 16 of the U.S. Treasury Department Model Income Tax Treaty of June 16, 1981, *reprinted in* 1 Tax Treaties (CCH) ¶ 158.

APPENDIX THREE

Article 28 of the German–United States Income Tax Treaty:⁶⁴⁹

1. A person that is a resident of a Contracting State and derives income from the other Contracting State shall be entitled, in that other Contracting State, to all the benefits of this Convention only if such person is:

- (a) an individual;
- (b) a Contracting State, or a political subdivision or local authority thereof;
- (c) engaged in the active conduct of a trade or business in the first-mentioned Contracting State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company), and the income derived from the other Contracting State is derived in connection with, or is incidental to, that trade or business;
- (d) a company in whose principal class of shares there is substantial and regular trading on a recognized stock exchange;
- (e) (aa) a person more than fifty percent of the beneficial interest in which (or in the case of a company, more than fifty percent of the number of shares of each class of whose shares) is owned, directly or indirectly, by persons entitled to benefits of this Convention under subparagraphs (a), (b), (d), or (f) or who are citizens of the United States; and

 (bb) a person, more than fifty percent of the gross income of which is not used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons not entitled to benefits of this Convention under subparagraphs (a), (b), (d) or (f) or who are not citizens of the United States; or
- (f) a not-for-profit organization that, by virtue of that status, is generally exempt from income taxation in its Contracting State of residence, provided that more than half of the beneficiaries, members, or participants, if any, in such organization are persons that are entitled, under this Article, to the benefits of this Convention.

⁶⁴⁹ Article 28 of the German–U.S. Income Tax Treaty, entered into force on August 21, 1991. Convention for the Avoidance of Double Taxation, Aug. 29, 1989, U.S.–F.R.G., *reprinted in* 2 Tax Treaties (CCH) ¶ 3249 (Feb. 1993).

2. A person that is not entitled to the benefits of this Convention pursuant to the provision of paragraph 1 may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income in question arises so determines.

3. For purposes of paragraph 1, the term "recognized stock exchange" means:

- (a) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934;
- (b) any German Stock Exchange on which registered dealings in shares take place;
- (c) any other stock exchange agreed upon by the competent authorities of the Contracting States.

4. The competent authorities of the Contracting States shall consult together with a view to developing a commonly agreed application of the provisions of this Article. The competent authorities shall, in accordance with the provision of Article 26 (Exchange of Information and Administrative Assistance), exchange such information as is necessary for carrying out the provisions of this Article and safeguarding, in cases envisioned therein, the application of their domestic law.

APPENDIX FOUR:

Article 26 of the U.S.–Netherlands Income Tax Treaty.⁶⁵⁰

1. A person that is a resident of one of the States and derives income from the other State shall be entitled, in that other State, to all the benefits of this Convention only if such person is:

- (a) an individual;
- (b) a State, or a political subdivision or local authority thereof;
- (c) a company meeting any of the following tests:
 - (i) the principal class of its shares is listed on a recognized stock exchange located in either of the States and is substantially and regularly traded on one or more recognized stock exchanges;
 - (ii) (A) more than 50% of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies which are resident of either State, the principal classes of the shares of which are listed and traded as described in subparagraph (c)(i), and

(B) the company is not a conduit company, as defined in subparagraph 8(m); or
 - (iii) in the case of a company resident in the Netherlands,
 - (A) at least 30% of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies resident in the Netherlands, the principal classes of the shares of which are listed and traded as described in subparagraph (c)(i);
 - (B) at least 70% of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies that are residents of the United States or of member states of the European Communities, the principal classes of shares of which are substantially and regularly traded on one or more recognized stock exchanges; and

⁶⁵⁰Article 26 (Limitation on Benefits) of the U.S.–Netherlands Income Tax Treaty (December 18, 1992).

(C) the company is not a conduit company, as defined in subparagraph 8(m); or

(iv) in the case of a conduit company (as defined in paragraph 8(m)) that satisfies the requirements of subparagraph (c)(ii)(A) or (c)(iii)(A) and (B), such company satisfies the conduit base reduction test set forth in paragraph 5(d);

(d) a person:

(i) more than 50% of the beneficial interest in which (or, in the case of a company, more than 50% of the aggregate vote and value of all of its shares, and more than 50% of the shares of any "disproportionate class of shares") is owned, directly or indirectly, by qualified persons; and

(ii) which meets the base reduction test described in paragraph 5; or

(e) a not-for-profit organization that, by virtue of that status, is generally exempt from income taxation in its State of residence, provided that more than half of the beneficiaries, members, or participants, if any, in such organization are qualified persons.

2. (a) A person resident in one of the States shall also be entitled to the benefits of this Convention with respect to income derived from the other State if such person is engaged in the active conduct of a trade or business in the first-mentioned State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company), and

(i) the income derived in the other State is derived in connection with that trade or business in the first-mentioned State and the trade or business of the income-recipient is substantial in relation to the income producing activity, or

(ii) the income derived in the other State is incidental to that trade or business in the first-mentioned State.

(b) Income is derived in connection with a trade or business if the income-producing activity in the other State is a line of business which forms a part of or is complementary to the trade or business conducted in the first-mentioned State by the income recipient.

(c) Whether the trade or business of the income recipient is substantial will generally be determined by reference to its proportionate share of the trade or business in the other State, the nature of the activities performed and the relative contributions made to the conduct of the trade or business in both States. In any case, however, the trade or

business of the income recipient will be deemed to be substantial if, for the preceding taxable year, the average of the ratios for the following three factors exceeds 10% (or in the case of a person electing to apply subparagraph (h), 60%) and each of the ratios exceeds 7.5% (or in the case of a person electing to apply subparagraph (h), 50%), provided that for any separate factor that does not meet the 7.5% test (or in the case of a person electing to apply subparagraph (h), the 50% test) in the first preceding taxable year the average of the ratios for that factor in the three preceding taxable years may be substituted:

(i) the ratio of the value of assets used or held for use in the active conduct of the trade or business by the income recipient in the first-mentioned State (without regard to any assets attributed from a third state under subparagraph (h), except in the case of a person electing to apply subparagraph (h)) to all, or, as the case may be, the proportionate share of the value of such assets so used or held for use by the trade or business producing the income in the other State;

(ii) the ratio of gross income derived from the active conduct of the trade or business by the income recipient in the first-mentioned State (without regard to any gross income attributed from a third state under subparagraph (h), except in the case of a person electing to apply subparagraph (h)) to all, or, as the case may be, the proportionate share of the gross income so derived by the trade or business producing the income in the other State; and

(iii) the ratio of the payroll expense of the trade or business for services performed within the first-mentioned State (without regard to any services attributed from a third state under subparagraph (h), except in the case of a person electing to apply subparagraph (h)) to all, or, as the case may be, the proportionate share of the payroll expense of the trade or business for services performed in the other State.

(d) Income derived from a State is incidental to a trade or business conducted in the other State if the income is not described in subparagraph (b) and the production of such income facilitates the conduct of the trade or business in the other State (for example, the investment of the working capital of such trade or business). In the case of a person electing to apply subparagraph (h), the income that is considered incidental to the trade or business shall not be greater than four times the amount of income that would have been considered incidental to the trade or business actually conducted in the Netherlands.

(e) A person that is a resident of one of the States is considered to be engaged in the active conduct of a trade or business in that State (and is considered to carry on all, or, as the case may be, the proportionate share of such trades or businesses) if such person:

(i) is directly so engaged;

(ii) is a partner in a partnership that is so engaged;

(iii) is a person in which a controlling beneficial interest is held by a single person which is engaged in the active conduct of a trade or business in that State;

(iv) is a person in which a controlling beneficial interest is held by a group of five or fewer persons each member of which is engaged in activity in that State which is a component part of or directly related to the trade or business in that State;

(v) is a company that is a member of a group of companies that form or could form a consolidated group for tax purposes according to the law of that State (as applied without regard to the residence of such companies), and the group is engaged in the active conduct of a trade or business in that State;

(vi) owns, either alone or as a member of a group of five or fewer persons that are qualified persons, residents of a member state of the European Communities, or residents of an identified state, a controlling beneficial interest in a person that is engaged in the active conduct of a trade or business in the State in which such owner is resident; or

(vii) is, together with another person that is so engaged, under the common control of a person (or a group of five or fewer persons) which (or, in the case of a group, each member of which) is a qualified person, a resident of a member state of the European Communities or a resident of an identified state.

For purposes of subparagraphs (e)(vi) and (e)(vii), an "identified State" includes any third country, identified by agreement of the competent authorities, which has effective provisions for the exchange of information with the State in which the person being tested under this paragraph is a resident.

(f) For purposes of subparagraph (e), a person (or group) shall be deemed to own a "controlling beneficial interest" in another person if it holds directly or indirectly a beneficial interest which represents more than 50% of the value and voting power in such other person, provided that:

(i) an interest consisting of 50% or less of the value and voting power of any third person shall be considered for purposes of determining the percentage of indirect ownership held in such other person; and

(ii) no person shall be considered to be part of a group owning a controlling beneficial interest in an entity unless such person holds directly a beneficial interest which represents at least 10% of the value and voting power in such entity.

(g) For purposes of subparagraph (e), a person (or group) shall be deemed to have "common control" of two persons if it holds a controlling beneficial interest in each such person.

(h) For purposes of applying the rules of this paragraph, where a person that is a resident of the Netherlands is engaged active conduct of a trade or business in the Netherlands (or considered to be so engaged under the rules of subparagraph (e)), and activity that is a component part of, or directly related to that trade or business, consistent with the rules of subparagraph (e), is also conducted in other Member States of the European Communities, that person may elect to treat all, or, as the case may be, the proportionate share of such activity as if it were conducted solely in the Netherlands, provided that each of the following three ratios exceeds 15%:

(i) the ratio of the value of assets used or held for use in the active conduct of the trade or business within the Netherlands (without regard to any assets attributed from a third state under this subparagraph) to all, or, as the case may be, the proportionate share of the value of such assets so used or held for use within all such member states;

(ii) the ratio of gross income derived from the active conduct of the trade or business within the Netherlands (without regard to any gross income attributed from a third state under this subparagraph) to all, or, as the case may be, the proportionate share of the gross income so derived within all such member states; and

(iii) the ratio of the payroll expense of the trade or business for services performed within the Netherlands (without regard to any services attributed from a third state under this subparagraph) to all, or, as the case may be, the proportionate share of the payroll expense of the trade or business for services performed within all such member states.

3. A person that is a resident of one of the States shall also be entitled to all the benefits of this Convention if that person functions as a headquarters company for a multinational corporate group. A person shall be considered a headquarters company for this purpose only if:

(a) it provides a substantial portion of the overall supervision and administration of the group, which may include, but cannot be principally, group financing;

(b) the corporate group consists of corporations resident in, and engaged in an active business in, at least five countries, and the business activities carried on in each of the five countries (or five groupings of countries) generate at least 10% of the gross income of the group;

(c) the business activities carried on in a state other than the State of residence of the headquarters company generate less than 50% of the gross income of the group;

(d) no more than 25% of its gross income is derived from the other State;

(e) it has, and exercises, independent discretionary authority to carry out the functions referred to in subparagraph (a);

(f) it is subject to the same income taxation rules in its country of residence as persons described in paragraph 2; and

(g) the income derived in the other State either is derived in connection with, or is incidental to, the active business referred to in subparagraph (b).

If the gross income requirements of subparagraphs (b), (c) or (d) of this paragraph are not fulfilled, they will be deemed to be fulfilled if the required ratios are met when averaging the gross income of the preceding four years.

4. (a) A company resident in the Netherlands shall also be entitled to the benefits of Article 10 (Dividends), 11 (Branch tax), 12 (Interest), or 13 (Royalties) if:

(i) more than 30% of the aggregate vote and value of all of its shares (and more than 30% of the shares of any "disproportionate class of shares") is owned, directly or indirectly, by qualified persons resident in the Netherlands;

(ii) more than 70% of all such shares is owned, directly or indirectly, by qualified persons and persons that are residents of member states of the European Communities; and

(iii) such company meets the base reduction test described in paragraph 5.

(b) In determining whether, pursuant to subparagraph (a)(ii), a company's shares are owned by residents of member states of the European Communities, only those shares shall be considered which are held by persons that are residents of states with a comprehensive income tax Convention with the United States, as long as the particular dividend, profit or income subject to the branch tax, interest, or royalty payment in respect of which treaty benefits are claimed would be subject to a rate of tax under that Convention that is no less favorable than the rate of tax applicable to such company under

Articles 10 (Dividends), 11 (Branch tax), 12 (Interest) or 13 (Royalties) of this Convention.

5. (a) A person meets the base reduction test described in this paragraph if:

(i) less than 50% percent of such person's gross income is used, directly or indirectly, to make deductible payments in the current taxable year to persons that are not qualified persons; or

(ii) in the case of a person resident in the Netherlands,

(A) less than 70% of such gross income is used, directly or indirectly, to make deductible payments to persons that are not qualified persons; and

(B) less than 30% of such gross income is used, directly or indirectly, to make deductible payments to persons that are neither qualified persons nor residents of member states of the European Communities.

(b) For purposes of this paragraph, the term "gross income" means gross income for the first taxable year preceding the current taxable year; provided that the amount of gross income for the first taxable year preceding the current taxable year will be deemed to be no less than the average of the annual amounts of gross income for the four taxable years preceding the current taxable year.

(c) For purposes of this paragraph, the term "deductible payments" includes payments for interest or royalties, but does not include payments at arm's length for the purchase or use of or the right to use tangible property in the ordinary course of business or remuneration at arm's length for services performed in the country of residence of the person making such payments. Types of payments may be added to or eliminated from the exceptions mentioned in the preceding definition of "deductible payments" by mutual agreement of the competent authorities.

(d) For purposes of paragraph 1(c), the conduit base reduction test means the base reduction test described in this paragraph, except that the term "deductible payments" for this purpose means only those payments described in subparagraph (c):

(i) that are made to an associated enterprise (as described in Article 9 (Associated enterprises), except that whether two enterprises are associated will be determined for this purpose without regard to the residence of either enterprise; and

(ii) that are subject to an aggregate rate of tax (including withholding tax) in the hands of the recipient that is less than 50% of the rate that would be

applicable had the payment been received in the State of residence of the payer, and subject to the normal taxing regime in that State.

6. A person, resident of one of the States, which derives from the other State income mentioned in Article 8 (Shipping and air transport) and which is not entitled to the benefits of this Convention because of the foregoing paragraphs, shall nevertheless be entitled to the benefits of this Convention with respect to such income if:

(a) more than 50% of the beneficial interest in such person (or in the case of a company, more than 50% of the value of the stock of such company) is owned, directly or indirectly, by qualified persons or individuals who are residents of a third state; or

(b) in the case of a company, the stock of such company is primarily and regularly traded on an established securities market in a third state, provided that such third state grants an exemption under similar terms for profits as mentioned in Article 8 of this Convention to citizens and corporations of the other State either under its national law or in common agreement with that other State or under a Convention between that third state and the other State.

7. A person resident of one of the States, who is not entitled to benefits of this Convention because of the foregoing paragraphs, may, nevertheless, be granted benefits of this Convention if the competent authority of the State in which the income in question arises so determines. In making such determination, the competent authority shall take into account as its guideline whether the establishment, acquisition, or maintenance of such person or the conduct of its operations has or had as one of its principal purposes the obtaining of benefits under this Convention. The competent authority of the State in which the income arises will consult with the competent authority of the other State before denying the benefits of the Convention under this paragraph.

8. The following provisions apply for purposes of this Article:

(a) the term "principal class of shares" is generally the ordinary or common shares of the company, provided that such class of shares represents the majority of the voting power and value of the company. When no single class of shares represents the majority of the voting power and value of the company, the "principal class of shares" is generally those classes that in the aggregate possess more than 50% of the voting power and value of the company. In determining voting power, any shares or class of shares that are authorized but not issued shall not be counted and in mutual agreement between the competent authorities appropriate weight shall be given to any restrictions or limitations on voting rights of issued shares.

The "principal class of shares" also includes any "disproportionate class of shares". Notwithstanding the preceding rules, the "principal class of shares" may be identified by mutual agreement between the competent authorities of the States.

(b) the term "shares" shall include depository receipts thereof or trust certificates thereof.

(c) the term "disproportionate class of shares" means any class of shares of a company resident in one of the States that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other State by particular assets or activities of the company.

(d) the term "recognized stock exchange" means:

(i) any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934;

(ii) the Amsterdam Stock Exchange;

(iii) the NASDAQ System owned by the National Association of Securities Dealers, Inc. or the parallel market of the Amsterdam Stock Exchange; and

(iv) any other stock exchange agreed upon by the competent authorities of both States, including, for this purpose, any stock exchanges listed in an exchange of notes signed at the later of the dates on which the respective governments have notified each other in writing that the formalities constitutionally required for the entry into force of the Convention as meant in Article 37 (Entry into force) in their respective States have been complied

However, with respect to closely held companies, the term "recognized stock exchange" shall not include the stock exchanges mentioned under subparagraph (iii), or if so indicated in mutual agreement between the competent authorities, under subparagraph (iv).

(e) the term "closely held company" means a company of which 50% or more of the principal class of shares is owned by persons, other than qualified persons or residents of a member state of the European Communities, each of whom beneficially owns, directly or indirectly, alone or together with related persons more than 5% of such shares for more than 30 days during a taxable year.

(f) the shares in a class of shares are considered to be substantially and regularly traded on one or more recognized stock exchanges in a taxable year if:

(i) trades in such class are effected on one or more of such stock exchanges other than in de minimis quantities during every month; and

(ii) the aggregate number of shares of that class traded on such stock exchange or exchanges during the previous taxable year is at least 6% of the average number of shares outstanding in that class during that taxable year.

For purposes of this subparagraph, any pattern of trades conducted in order to meet the “substantial and regular trading” tests will be disregarded.

(g) the term “qualified person” means:

(i) a person that is entitled to benefits of this Convention pursuant to the provisions of paragraph 1; and

(ii) a citizen of the United States.

(h) the term “member state of the European Communities” means, unless the context requires otherwise:

(i) the Netherlands; and

(ii) any other member state of the European Communities with which both States have in effect a comprehensive income tax Convention.

(i) the term “resident of a member state of the European Communities” means a person that would be considered a resident of any such member state under the principles of Article 4 (Resident) and would be entitled to the benefits of this Convention under the principles of paragraph 1, applied as if such member state were the Netherlands, and that is otherwise entitled to the benefits of the Convention between that person's state of residence and the United States.

(j) the not-for-profit organizations referred to in subparagraph 1(e) of this Article include, but are not limited to, pension funds, pension trusts, private foundations, trade unions, trade associations, and similar organizations, provided, however, that in all events, a pension fund, pension trust, or similar entity organized for purposes of providing retirement, disability, or other employment benefits that is organized under the laws of a State shall be entitled to the benefits of the Convention if the organization sponsoring such fund, trust, or entity is entitled to the benefits of the Convention under this Article.

(k) the reference in subparagraph (c)(ii) and clauses (A) and (B) of subparagraph (c)(iii) of paragraph 1 to shares that are owned, directly or indirectly, shall mean that all companies in the chain of ownership that are used to satisfy the ownership requirements of the respective clause or subparagraph, must meet the residence requirements that are described in such clause or subparagraph.

(l) for the purpose of paragraphs 2, 3 and 5, the competent authorities may by mutual agreement, notwithstanding the provisions of these paragraphs, determine transition rules for newly-established business operations, newly-established corporate groups or newly-established headquarters companies.

(m) for purposes of subparagraph (1)(c)(ii)(B) and (1)(c)(iii)(C), the term “conduit company” means a company that makes payments of interest, royalties and any other payments included in the definition of deductible payments (as defined in subparagraph (5)(c)) in a taxable year in an amount equal to or greater than 90% of its aggregate receipts of such items during the same taxable year. Notwithstanding the previous sentence, a bank or insurance company shall not be considered to be a conduit company if it (i) is engaged in the active conduct of a banking or insurance business and (ii) is managed and controlled by associated enterprises (within the meaning of Article 9 (Associated enterprises), except that whether two enterprises are associated will be determined for this purpose without regard to the residence of either enterprise) that are qualified persons.

APPENDIX FIVE:

Article 17 of the U.S.–Mexico Income Tax Treaty.⁶⁵¹

1. A person that is a resident of a Contracting State and derives income from the other Contracting State shall be entitled under this Convention to relief from taxation in that other Contracting State only if such person is:

- (a) an individual;
- (b) a Contracting State, or a political subdivision or local authority thereof;
- (c) engaged in the active conduct of a trade or business in the first-mentioned State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company) and the income derived from the other Contracting State is derived in connection with, or is incidental to, that trade or business;
- (d) either
 - (i) a company in whose principal class of shares there is substantial and regular trading on a recognized securities exchange located in either of the States;
 - (ii) a company which is wholly owned, directly or indirectly, by a resident of that Contracting State in whose principal class of shares there is such substantial and regular trading on a recognized securities exchange located in either of the States; or
 - (iii) a company which is
 - (A) wholly owned, directly or indirectly, by residents of any State that is a party to the North American Free Trade Agreement (“NAFTA”) in whose principal class of shares there is such substantial and regular trading on a recognized securities exchange;
 - and

⁶⁵¹ Article 17 (Limitation on Benefits) of the U.S.–Mexico Income Tax Treaty (September 18, 1992).

(B) more than 50% owned, directly or indirectly, by residents of either Contracting State in whose principal class of shares there is such substantial and regular trading on a recognized securities exchange located in such a State;

(e) an entity that is a not-for-profit organization (including a pension fund or private foundation) and that, by virtue of that status, is generally exempt from income taxation in its Contracting State of residence, provided that more than half of the beneficiaries, members or participants, if any, in such organization are entitled, under this Article, to the benefits of this Convention;

(f) a person that satisfies both of the following conditions:

(i) more than 50% of the beneficial interest in such person (or in the case of a company, more than 50% of the number of shares of each class of the company's shares) is owned, directly or indirectly, by persons entitled to the benefits of this Convention under subparagraphs (a), (b), (d) or (e); and

(ii) less than 50% of the gross income of such person is used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons not entitled to the benefits of this Convention under subparagraphs (a), (b), (d) or (e); or

(g) a person claiming benefits under Articles 10 (Dividends), 11 (Interest), 11A (Branch tax), or 12 (Royalties) that satisfies the following conditions:

(i) more than 30% of the beneficial interest in such person (or, in the case of a company, more than 30% of the number of shares of each class of the company's shares) is owned, directly or indirectly, by persons resident in a Contracting State and entitled to the benefits of this Convention under subparagraphs (a), (b), (d), or (e);

(ii) more than 60% of the beneficial interest in such person (or, in the case of a company, more than 60% of the number of shares of each class of the company's shares) is owned, directly or indirectly, by persons resident in a state that is a party to NAFTA; and

(iii)

(A) less than 70% of the gross income of such person is used directly or indirectly to meet liabilities (including liabilities for interest or royalties) to persons that are not entitled to the benefits of this Convention under subparagraphs (a), (b), (d), or (e); and

(B) less than 40% of the gross income of such person is used directly or indirectly to meet liabilities (including liabilities for interest or royalties) to persons that are neither entitled to the benefits of this Convention under subparagraphs (a), (b), (d), or (e) nor residents of a state that is a party to NAFTA.

A resident of a State that is a party to NAFTA shall only be considered as owning a beneficial interest (or share) under subparagraph (g)(ii) if that State has a comprehensive income tax Convention with the Contracting State from which the income is derived and if the particular dividend, profit or income subject to the branch tax, interest, or royalty payment, in respect of which benefits under this Convention are claimed, would be subject to a rate of tax under that Convention that is no less favorable than the rate of tax applicable to such resident under Articles 10 (Dividends), 11 (Interest), 11A (Branch tax), or 12 (Royalties) of this Convention.

2. A person which is not entitled to the benefits of the Convention pursuant to the provisions of paragraph 1 may, nevertheless, demonstrate to the competent authority of the State in which the income arises that such person should be granted the benefits of the Convention. For this purpose, one of the factors the competent authorities shall take into account is whether the establishment, acquisition, and maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention.