

January 2012

Canada-United States Tax Regime, The

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Recommended Citation

Jon Groetzinger, E. Miller Williams, and Jeffrey Shafer, *Canada-United States Tax Regime, The*, 36 *Can.-U.S. L.J.* 209 (2011)
Available at: <https://scholarlycommons.law.case.edu/cuslj/vol36/iss1/13>

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THE CANADA-UNITED STATES TAX REGIME

Session Chair – Jon Groetzinger
United States Speaker – E. Miller Williams
Canadian Speaker – Jeffrey Shafer

INTRODUCTION

Jon Groetzinger

MR. GROETZINGER: Good morning to everyone. Thank you for coming out bright and early on a Saturday morning for seventy-five minutes of tax updates. Quite appropriately, we have five days left to get our tax returns in or file for extensions. It is always a great time of year.

Today we have two speakers who will give us an update on the United States-Canada Tax Treaty and transfer pricing issues. Jeffrey Shafer is an associate with Blake Cassels in Toronto.¹ A former mechanical engineer educated at the University of Waterloo, he has become a tax lawyer and has won many awards.

Miller Williams is from Ernst and Young out of Atlanta, Georgia² and is an expert in transfer pricing issues and advance pricing agreements. We will start today with Mr. Williams and his discussion about advance pricing agreements.

¹ *Jeffrey Shafer*, BLAKES, <http://www.blakes.com/english/people/lawyers2.asp?LAS=FRE> (last visited Jan. 10, 2011).

² CAN.-U.S. L. INST., 2010 CONFERENCE PROGRAM 23 (2010), *available at* http://cusli.org/conferences/annual/annual_2010/documentation/Final_program.pdf.

UNITED STATES SPEAKER

*E. Miller Williams**

MR. WILLIAMS: Good morning, and I thank you for the opportunity to talk with you about transfer pricing, specifically as it relates to the United States-Canada Income Tax Treaty,³ advance pricing agreements, and the arbitration provisions of the Treaty⁴ that have recently come into play.

In terms of today's agenda, let me just provide a basic background on transfer pricing. Transfer pricing is how companies transfer goods, services, and intellectual property among their related or affiliated groups of companies around the world.⁵ It is very important because, based on this pricing, if you have a significant amount of intercompany transactions for a particular legal entity or consolidated group of taxpayers in a country, it will lead to

* E. Miller Williams, Jr. of Ernst & Young consults with multinational corporate clients on a national basis regarding complex transfer pricing matters with an emphasis on international transfer pricing controversy, advanced pricing agreements (APA), competent authority, and transfer pricing planning and structuring.

Mr. Williams has over eighteen years of transfer pricing consulting experience (five with the government and thirteen in private practice) with companies in a variety of industries. His industry experience includes work with paper and pulp, building products, pharmaceutical, semiconductors, software, packaging, retail, consumer products, motor vehicles, automotive parts, heavy equipment, and industrial machinery. Mr. Williams is a frequent speaker at Council for International Tax Education Seminars and other tax seminars and has authored a number of transfer pricing articles.

Earlier, Mr. Williams headed the Southeast transfer pricing practices of a previous Big 5 Firm and of one of the current Big 4 Firms in Atlanta. Prior to private practice, Mr. Williams served as a senior attorney in the Office of Associate Chief Counsel (International) for the IRS in Washington, D.C. working on a variety of transfer pricing and international tax matters. As a member of that office, he worked in the APA Program where he acted as lead attorney on many APA cases and as advisor to the director on APA procedures.

Mr. Williams received his LLM in taxation from Emory, his J.D. from Stetson University College of Law and his undergraduate degree from Vanderbilt. Prior to working for the IRS, he served as an officer and attorney in the U.S. Army Judge Advocate General's Corps where he held positions as a prosecutor, defense attorney, and administrative law attorney. He is a member of the Georgia Bar Association and the American Bar Association Tax Section, and is a board member and officer of the Georgia Council for International Visitors and board member of the Atlanta Area Council of the Boy Scouts of America.

³ United States-Canada Income Tax Treaty, U.S.-Can., Sept. 26, 1980, T.I.A.S. No. 11,087.

⁴ Revised Protocol Amending the Convention Between the United States and Canada with Respect to Taxes on Income and on Capital, art. 14, U.S.-Can., April 12, 1995, S. Treaty Doc. No. 104-4 [hereinafter Revised Protocol].

⁵ Eduardo Baistrocchi, *The Transfer Pricing Problem: A Global Proposal for Simplification*, 59 TAX L. 941, 949 (2006).

profit for that company; profit, in turn, will determine a company's taxable income.

From a tax authority standpoint, determining the value of this transfer pricing is extremely important because it will ultimately determine the amount of tax that must be paid. Transfer pricing, based on a number of surveys done by Ernst and Young and other accounting firms, is really the most important international tax concern for our clients who are large, multinational companies.⁶

Transfer pricing is a very subjective area. There are not many black and white answers in the transfer pricing field. We have lawyers, economists, and business people working together, trying to make transfer pricing as scientific or quantitative as possible. In reality, however, it is very subjective; it is based on the particular facts and circumstances of the transactions and tax payers.

A lot of planning goes into transfer pricing; you want to be able to set in advance the functions and risks of a legal entity in order to assist in analyzing the transfer pricing. This pricing is based on the arm's-length standard, or how two parties would negotiate in terms of the transfer price.⁷ This may be different from what you are familiar with for state corporate income tax purposes. In the United States, some states have an arm's-length principle⁸ while most have an apportionment principle.⁹ The apportionment principle looks at the profits of a United States company; these total profits are then divided into each state based on things such as sales, assets, or wages that are in that particular state. This carves out what should be the state taxable income. That is different from the arm's-length principle. The arm's-length principle has been used in the international area by the Department of Treasury,¹⁰ the Organization for Economic Cooperation and Development

⁶ See, e.g., ERNST & YOUNG, A GLOBAL PERSPECTIVE ON YOUR INTERNATIONAL TAX CONCERNS 2-3 (2010), available at [http://www.ey.com/Publication/vwLUAssets/TransfPric_brochure/\\$FILE/TransfPric_brochure.pdf](http://www.ey.com/Publication/vwLUAssets/TransfPric_brochure/$FILE/TransfPric_brochure.pdf) (stating the company's policies and services surrounding transfer pricing).

⁷ See Reuven S. Avi-Yonah, *The Rise and Fall of Arm's-Length: A Study in the Evolution of International Taxation*, 15 VA. TAX REV. 89, 91-92 (1995).

⁸ See generally Beverly L. Hayes, *Constitutional Law: Due Process and Commerce Clause Concerns in State Taxation of Multinational Corporations in Wake of the Barclays Case*, 9 FLA. J. INT'L L. 317, 328 (1994) (discussing how the use of the arm's-length principle is the consequence of tax treaties for some states).

⁹ See generally Joseph M. Dodge, *What Federal Taxes are Subject to the Rule of Apportionment Under the Constitution?*, 11 J. CONST. L. 839, 841 (stating that "any federal tax that is a 'direct tax' . . . must be apportioned among the states in accordance with the respective populations of the various states.").

¹⁰ See generally Roger Feinschreiber & Margaret Kent, *Treasury Department Suggests Transfer Pricing Revisions*, 846 PRACTISING L. INST.: TAX L. & ESTATE PLANNING COURSE HANDBOOK SERIES 27, 33 (2008) (discussing revisions that clarify the proper application of the arm's-length principle in international tax issues).

(OECD),¹¹ and foreign governments around the world.¹² The transfer pricing guidelines of these organizations have all affirmed the arm's-length standard as opposed to the apportionment standard. Generally, with the exception of Brazil, most of the countries follow the arm's-length standard.¹³

To give you an example, say we have a United States company that makes widgets, and it sets up a distributor in Canada. The company sells the widgets to the distributor in Canada, and the distributor sells the widgets to customers. If the United States company sells the products to the distributor at a high price, and if after adding selling and startup costs to this price the total costs are greater than the price for which the product is sold, then the company will end up with a loss. In that example, the question is really a matter of which company bears that startup cost in terms of setting the price. Should the United States sell it at a lower price, allowing Canada to resell it and make a profit? This is an example of what we are talking about in terms of the pricing, whether it is a United States company selling in Canada or a Canadian company selling in the United States to its related subsidiary in the other country.

It could also be a situation of intellectual property—whether it is a patent, copyright, or trademark being charged up to the Canadian manufacturer. Also, if you have a United States-based retailer that has set up stores and then goes up to Canada and begins to set up more stores, what should they charge for the use of the name? Or it could be the system of operations that is being sold or relationships with vendors, or even services rendered by the United States company for the benefit of the Canadian company. All of these come into play when dealing with transfer pricing.¹⁴

What if you have two plants—one in Canada and the other in the United States—that are making product, and the American parent company decides to close the Canadian company? Who should bear all of the restructuring costs in this situation? These are a number of the issues that arise with transfer pricing.

As you can see, both parties, the Canadian side¹⁵ and the Internal Revenue Service (IRS)¹⁶ side, have transfer pricing rules in place. There are also pen-

¹¹ See generally ORG. FOR ECON. COOPERATION & DEV., OECD TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (2010) (providing guidelines on how enterprises should apply the arm's-length principle to the valuation of cross-border transactions).

¹² Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1339 (1996).

¹³ Marcos Valadao & Nara Galeb Porto, *MERCOSUR, NAFTA, FTAA and its Effects in Federal Taxation of International Transactions Between the United States and Brazil: A Comparative Study*, 10 L. & BUS. REV. AM. 705, 721 (2007).

¹⁴ Baistrocchi, *supra* note 5.

¹⁵ Income Tax Act, R.S. 1985, c. 1, s. 247 (Can.).

alty provisions in place in both countries.¹⁷ Canada's penalties are actually more severe in some respects. For example, there is a ten percent penalty in Canada on the amount of adjustment,¹⁸ whereas in the United States, the penalty is on the amount of additional tax paid.¹⁹

We also now have Financial Accounting Standards Board Interpretation Number 48 (FIN 48) provisions for companies in terms of assessing their taxes,²⁰ which provides greater certainty in assessing transfer pricing. To give a basic explanation, the United States IRS has asked for disclosure on the tax returns going forward of all uncertain tax positions,²¹ as well as the FIN 48 positions of companies.²² I think we are going to see a lot more controversy around this because of those provisions.

One of the ways to minimize transfer pricing issues is through the use of bilateral Advance Pricing Agreements (APA).²³ We are going to talk about that in detail, and I will try to specifically relate it to the United States and Canada. I will also discuss the steps that need to be taken to successfully negotiate an APA in addition to the competent authority provisions or mutual agreement procedures that we have in income tax treaties around the world, specifically for Canada and the United States. These provisions are designed to prevent double taxation,²⁴ and, from a transfer pricing standpoint, that can be considered a success. In other words, success could mean a company ends up paying tax on profits due to transfer pricing in only one jurisdiction. Perhaps the ultimate success, however, is when companies are actually able—through transfer pricing functions, risk, and alignment—to put the profit into a low-tax jurisdiction.

But when dealing with Canada and the United States, two high-tax countries,²⁵ it may just depend on each company's situation. Several different factors come into play such as losses, financing arrangements, or use of foreign tax credits.²⁶ In terms of United States and Canada, many times you are

¹⁶ 26 U.S.C. § 482 (1986).

¹⁷ Income Tax Act, R.S. 1985, c. 1, s. 247(3) (Can.); *Id.* § 6662(e)(1)(B).

¹⁸ Income Tax Act, R.S. 1985, c. 1, s. 247(3) (Can.).

¹⁹ 26 U.S.C. § 6662(a).

²⁰ Fin. Acct. Standards Board, *FASB Interpretation No. 48: Accounting for Uncertainty in Income Taxes*, FIN. ACCT. SERIES, June 2006, at 19-20.

²¹ Announcement 2010-9, 2010-7 I.R.B. 408.

²² *Id.*

²³ Avi-Yonah, *supra* note 7, at 153.

²⁴ *Id.*

²⁵ Charles I. Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151, 1193 (1981); Arthur J. Cockfield, *The Rise of the OECD as Informal "World Tax Organization" Through National Responses to E-Commerce Tax Challenges*, 8 YALE J. L. & TECH. 136, 162 (2006).

²⁶ See generally Baistrocchi, *supra* note 5 (discussing the mechanics of transfer pricing manipulation).

just trying to arrange a situation in which a company is not subject to double taxation.

Sometimes you have other countries with a low tax that do come into play. For example, the United States could be licensing know-how to a related party in Ireland, and then the party in Ireland sells product into Canada, and maybe Canada makes an adjustment on the transfer pricing. How do you deal with these issues among multiple countries? One of the issues that has come up over the years in competent authority is how the two governments can be forced to come together to reach an agreement. This may be difficult, because each country may want to put more taxable income into their respective locations. To solve this problem, there are what we call the arbitration provisions. The United States has this type of provision in only a couple of treaties, perhaps in those with Germany,²⁷ Belgium,²⁸ and Canada.²⁹ We will talk about these arbitration provisions, but the idea is that if a case cannot be settled in a reasonable amount of time, it will be pushed into the arbitration procedure to be settled. The goal, of course, is to never have to resort to the arbitration procedures.

In terms of developing transfer pricing, it is really a life cycle of planning that involves analysis, compliance, and then documentation.

When we talk about documentation, we mean the actual transfer pricing studies³⁰ and how they are presented on tax returns. Both countries have proper forms for this procedure. Canada has a T106 form,³¹ and the United States has forms 5472 or 5471.³² On these forms, a company must list the related party transactions;³³ in addition, the Canadian forms specifically ask whether there is documentation in place at the time of filing the tax return.³⁴ Throughout this process, a company must also check to ensure that its policy

²⁷ 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, U.S.-F.R.G., art. 25, Aug. 29, 1989, S. Treaty Doc. No. 101-10.

²⁸ Convention between the United States of America and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Belg., art. 24, July 9, 1970, S. Treaty Doc. No. 110-3.

²⁹ Revised Protocol, *supra*, note 4.

³⁰ Marc M. Levey & Cym H. Lowell, *Transfer Pricing Exam Strategy Evolves to a New Standard*, 6 J. INT'L TAX. 504, 507 (1995).

³¹ CAN. REVENUE AGENCY, FORM T106: INFORMATION OF NON-ARM'S LENGTH TRANSACTIONS WITH NON-RESIDENTS (2008), available at <http://www.cra-arc.gc.ca/E/pgb/tf/t106/t106-fill-08e.pdf>.

³² I.R.S., FORM 5471: INFORMATION RETURN OF U.S. PERSONS WITH RESPECT TO CERTAIN FOREIGN CORPORATIONS (2007), available at <http://www.irs.gov/pub/irs-pdf/f5471.pdf>; I.R.S. FORM 5472: INFORMATION OF U.S. PERSONS WITH RESPECT TO CERTAIN FOREIGN CORPORATIONS (2007), available at <http://www.irs.gov/pub/irs-pdf/f5472.pdf>.

³³ *Id.*; see also Form T106, *supra* note 31.

³⁴ Form T106, *supra* note 31.

is being followed, and, at the end of the year, a company may have to make what is called a “compensating adjustment” to adjust the transfer pricing to bring it in line with the company’s policy.³⁵

One of the problems with making these adjustments, however, relates to customs: transfer pricing now uses an arm’s-length principle, and customs does not. While customs is actually working with something similar, it is still different in terms of actual transaction values. When companies have transferred goods and put a specific price on a customs form—either going in or out of the United States or Canada—under United States transfer pricing rules, it is important that the values for transfer pricing and customs correspond in some manner.³⁶ Provision 1059(a) prevents importers from jeopardizing government revenue by valuing merchandise inconsistently for customs and tax purposes.³⁷ While the Provision 1059(a) does recognize differences between the value for transfer pricing and customs, it still is important that these match up; otherwise, companies may run into customs valuation issues.

Now I want to discuss APAs. During the 1980s, transfer pricing became more of an issue with the IRS,³⁸ first with pharmaceutical companies and then with inbound companies to the United States. What we saw is that these cases became very controversial. In some cases, there were situations in which the auditor had a particular position while the company had a different position, which caused these cases to become very personal. As a matter of fact, I was fortunate to be working for the IRS in the early 1990s when this program was just beginning. I would be at meetings in which I was surrounded by IRS employees on one side and company representatives on the other. We really had to work hard to listen to both sides, trying to bring them together and minimize the controversy and ill will that was in the room.

Though controversial in the beginning, this program has been very successful for the IRS and for taxpayers as a way to come together to resolve transfer pricing issues. In the bilateral context, that we are going to talk about, it has been very much a success. We also have, what we call, unilateral APAs. Both Canada and the IRS will issue unilateral APAs.³⁹ Howev-

³⁵ Announcement 2000-35, 2000-16 I.R.B. 922.

³⁶ Marc M. Levey & Robert L. Eisen, *The Transfer Pricing and Customs Duties Practice in the United States*, 893 PRACTISING L. INST.: TAX L. & PRAC. 547, 565 (2009).

³⁷ *See generally id.* (“If the value is adjusted downward, then Section 1059A will do no damage because it acts as a cap on the IRS inventory basis. On the other hand, if the value is adjusted upward, then Section 1059A can be problematic for the taxpayer because the tax basis would be limited to the value declared to customs at the time of import unless adjusted through the reconciliation prototype.”).

³⁸ Steven C. Wrappe, *Negotiating an Advance Pricing Agreement*, 846 PRACTISING L. INST.: TAX L. & PRAC. 64, 74 (2008).

³⁹ Deanehan et al., *Making Better Use of APA and MAP Programs*, 19 J. INT’L TAX. 32, 37

er, we also have bilateral or multilateral APAs in which companies and countries come together and resolve transfer pricing disputes through the competent authority provisions.

The APA is a contract between the IRS and the United States taxpayer.⁴⁰ Similarly, with a bilateral APA, there is a contract between the Canadian Revenue Agency (CRA) and the Canadian company.⁴¹ It sets out the agreement on the facts and the transfer pricing methodology. When we talk about transfer pricing methodology under the transfer pricing rules, we have certain methods that apply to tangible property and intangible property and services.⁴² One of these methods would be comparable uncontrolled price.⁴³ There is the resale price, which looks at gross margins for distributors.⁴⁴ There is also a “cost plus” that looks at typical cost plus for manufacturers.⁴⁵ One of the methods, based on the IRS reports for transfer pricing about the APA program, is the comparable profits method, or the transactional net margin method, which is the OECD version.⁴⁶ There is also what is called a profit-split method, whereby the routine returns for activities are determined, then looking at excess profit and agreeing to split that or share that in some way. Many times in a bilateral APA, or in a competent authority matter, this profit split comes into play, where each side is trying to understand what is the residual or excess profit in the system and figure out which part should be in their country and why.

The bilateral APA then agrees on an arm’s-length range of results, which is based on the arm’s-length standard, and is typically for five years.⁴⁷ It can be slightly longer, and it can be renewed. It can also be rolled back if you were to reach an APA for tax years going forward. This is based on locations in which the company has not actually filed the return. If we have a taxpayer wanting to roll back in the calendar year of 2009, we can cover 2009, assuming they have not filed their 2009 tax return until June 30 in Canada or until September 15 in the United States. If that taxpayer files their return, that year can be covered; however, 2008 and years prior cannot be covered because those years are already filed. Assuming the facts and circumstances are similar in the APA years, you are able to rollback the agreement to those years through competent authority and seek resolution.

(2008).

⁴⁰ Announcement 2000-35, *supra* note 35.

⁴¹ *Id.*

⁴² *Id.*

⁴³ Treas. Reg. § 1.482-3(b) (2011).

⁴⁴ *Id.* § 1.482-3(c).

⁴⁵ *Id.* § 1.482-3(d).

⁴⁶ *Id.* § 1.482-5.

⁴⁷ Dennis I. Meyer & William D. Outman II, *U.S. Tax and Customs Consequences of Dealing with a Related Foreign Supplier—Part 2*, 13 J. INT’L TAX. 16, 26 (2002).

What you could have is a client that has an ongoing audit for 2005, 2006, and 2007. You then file for an APA to cover the years going forward, followed by rolling it back to cover this audit and the in-between years, which are those years that are not under audit and are not in the APA. Critical assumptions are put into the actual contract between the taxpayer, the IRS, and Canada in order to provide an out. If there were substantial changes in the business, or in other circumstances, there may be a possibility for renegotiation. For example, in light of the major economic downturn, companies that had established the right critical assumptions were able to go back and renegotiate the terms of the APA.

The IRS procedure that covers APAs and these procedures is 2006-9. Canada has a similar circular that covers the APA. I will briefly discuss the APA process. The following are the necessary phases in the APA process, which apply to both Canada and the United States either unilaterally or bilaterally: (1) the analysis phase; (2) the prefiling conference; (3) the APA request; (4) the negotiation; and (5) the drafting and administration, which describes the annual reports that are filed after each year.⁴⁸ These steps only summarize the general process for establishing an APA; there are many more detailed steps that must be completed.

In the first phase, a company must undergo data gathering to understand the facts, circumstances, and economic analysis and thereby develop a strategy for APA negotiations. In developing such a strategy a company must decide whether it will make a more technical argument; whether it will make an argument based on facts and circumstances; whether it will rely on internal comparables or external comparables; and whether it needs to make any adjustments to those comparables. In addition, a company may need to determine what to do in terms of any losses in Canada or the United States.

In the second phase, the company prepares a prefiling document.⁴⁹ This requires actually going into the IRS or the CRA for a prefiling conference.⁵⁰ The prefiling conference was originally designed because it gave companies an opportunity to come in and talk to the IRS about the program, to see how it worked, and to provide an opportunity to give feedback based on how much information is provided and what the desired ultimate outcome would be. Because in the beginning companies were worried about it, there is a provision that allows for both anonymous APA prefiling and a known prefiling. In an anonymous prefiling conference, the taxpayer's name is not revealed to the IRS. The company comes in to meet with the taxing authority, and, in some cases, they may not reveal any information or details about their

⁴⁸ Salvador M. Borraccia & Marc M. Levey, *A Guide to Canadian Transfer Pricing*, 14 J. INT'L TAX. 12, 48 (2003).

⁴⁹ Pricing Agreements, [2009] Fed. Tax. Income, Est. & Gifts ¶ 79.14, at 2 (Can.).

⁵⁰ Borraccia & Levey, *supra* note 48.

company or their identity. While the authorities do not actually make people wear a bag over their head, the process is anonymous.

The primary difference between an anonymous filing and a known filing is that with a known taxpayer, the IRS will notify the local IRS field office about the taxpayer, and then the field office could actually participate in the conference. If you had an audit going on that was not going well, you would not want to have a known prefiling conference because the field office would then attend the meeting. On the other hand, a company may want the field office to attend the meeting. For instance, it might be part of their strategy to try to work with the field office to resolve any issues. In the case of the bilateral APA, typically, there is a prefiling meeting with Canada or a prefiling meeting with the IRS to understand their respective positions. This also allows for feedback regarding what should go into the ultimate submission.

There are also requirements for the timing of an APA request. In the United States, a request can be filed by September 15 to cover 2009, and then there is another 120 days to file the actual submission.⁵¹ With another 120 days, a company would have until January to cover the prior year. In terms of the request, it is similar to a transfer pricing study—it lays out all the facts and circumstances, economic analyses, and sets out the position—but some additional information is provided. The overall APA is designed to be a cooperative process between the IRS and the taxpayer. At the prefiling, the IRS or CRA may say they are looking for a particular type of information, and that must be specifically addressed in the actual request.

The documents that you present to the IRS and to CRA in the case of a bilateral APA are typically the same documents. Whatever information is being provided to one tax authority is being provided to the other tax authority. In terms of your strategy, the goal is to understand the IRS' and the CRA's positions, and then to try to bring the two governments together. That process starts in a prefiling and in this request.

To give a very simple example, say I had a royalty that I was going to charge from a United States to a Canadian company. If the IRS did some analysis to determine that the royalty rate should be around six percent, while Canada did some analysis and found that the royalty rate should be one percent, then in order to prevent double taxation, I must work with the client and leverage available information, facts, and circumstances; in addition, I would likely try to bring the two governments together. The end result would hopefully be around three or four percent, instead of deferring completely to the IRS in terms of the higher rate. The latter option would significantly decrease my chances of getting CRA approval. Similarly, if a company is try-

⁵¹ Steven C. Wrappe & Kerwin Chung, *Negotiating an Advance Pricing Agreement*, 788 PRACTISING L. INST.: TAX L. & PRAC. 11, 40 (2007).

ing to take the CRA's position of one percent, the IRS is also going to be hesitant to give its approval.

Once a company files the request, it would then move into the negotiation procedures and start to negotiate with the governments. The IRS will send information requests and respond to those requests. Again, if the IRS issues information requests and a company responds, then the company would also provide the same information to Canada.

Also, at this time, the Canadian side tends to do more site visits, and they would come, if it were a facility in Canada, to do interviews with people on-site. They would also come to the United States and potentially do interviews with people there, and if there were some kind of site visit to see the plant or facility, they would do interviews there also.

Once negotiations begin, the IRS side will form an APA team. The team is comprised of a team leader from the APA program, team members from competent authority and the field, in addition to economists from within the APA program. This team then formulates and submits a negotiation position to competent authority, and competent authority will then go to Canada and negotiate.

The APA office is under chief counsel's office for the IRS. The Tax Treaty Division⁵² that handles the competent authority is under the IRS Large Business & International Division⁵³ for large to mid size cases and cases in the international area. On the Canadian side, the APA and the competent authority are really one group.

So, after the position paper is formed, it goes to competent authority, and then the two governments come together. Once settlement is reached, then the parties enter into a national agreement.

We do several things to try to make the process run more smoothly. We try to keep APA teams as small as possible—at the same time, we cannot prevent the IRS from adding people to its team. We also try to get more taxpayers involved. The IRS and the CRA want to hear from the taxpayer about the facts and the business issues. In addition, we try to standardize some of the filings in order to minimize fees. And, of course, we keep following up with the government.

One of the issues right now is that it takes a long time to complete APAs because the government lacks sufficient resources. The United States, for example, has several hundred APAs pending.⁵⁴ In a recent report it was

⁵² "Tax Treaty Division" is referenced in several Announcements. *E.g.*, Announcement 97-61, 1997-29 I.R.B. 13.

⁵³ *Large Business and International Tax Center*, IRS, <http://www.irs.gov/businesses/article/0,,id=102172,00.html> (last updated Jan. 4, 2011).

⁵⁴ See INTERNAL REVENUE SERVICE, ANNOUNCEMENT AND REPORT CONCERNING ADVANCE PRICING AGREEMENTS 11 (2010), available at <http://www.irs.gov/pub/irs-utl/2009finalstatutoryreport.pdf> (stating there are currently 352 pending requests for APAs).

shown that the United States had 127 filed,⁵⁵ and the time frame to complete a bilateral agreement is approximately forty-five months.⁵⁶ The report was ordered by Congress a few years ago in lieu of the tax publications asking for actual publication of the APAs. That was upheld to be taxpayer information, and settlement was given whereby this annual report would be issued. The report contains a lot of information about the APA program from the United States side. Canada issues a similar report.⁵⁷ They have an inventory of about eighty-five cases with thirty-five new cases filed in the last year.⁵⁸ Typically, they have had approximately twenty cases filed a year. Obviously, that has really grown.

In terms of cost, the APA can be a very expensive process. But if you are settling ten years of transfer pricing, as opposed to doing a transfer pricing study every single year, it can work out to be a fairly reasonable amount, particularly when you calculate it on a per-year basis and have millions of dollars of transfers occurring.

Many practitioners and companies would say Canada is one of the countries with the greatest enforcement of transfer pricing.⁵⁹ I have seen audits where, right from the beginning, the Canadian tax authority denied all service charges, and the United States company had to try to go back and prove those charges. With that happening, and with the IRS also auditing inbound companies, we have had a lot of controversy.

Perhaps for smaller companies or those with issues that are not ongoing, the competent authority process is a good one. This process exists under the Income Tax Treaty.⁶⁰ The two governments take the competent authority requests and then come together to negotiate the resolution of the case; their goal is to avoid double taxation. The process may not produce the exact result that the company would want, but there is a good chance that it will produce a reasonable result. The statistics indicate that approximately ninety to ninety-five percent of the time, it works out that no amount is subject to double taxation.⁶¹ The components that the request requires are set out for the

⁵⁵ *Id.* at 10 (stating there were 127 APAs filed in the United States in 2009).

⁵⁶ *Id.* at 11.

⁵⁷ CAN. REVENUE AGENCY, ADVANCE PRICING ARRANGEMENT PROGRAM REPORT 2009-2010 (2010), available at http://www.cra-arc.gc.ca/tx/nrdsnts/cmp/p_rprt10-eng.pdf.

⁵⁸ *Id.* at 7.

⁵⁹ See Mitch Feldman, *U.S. and Canada Grapple over Transfer Pricing Differences*, A.E. FELDMAN (Sep. 9, 2009, 8:50 AM), <http://blog.aefeldman.com/2009/09/09/us-and-canada-grapple-over-transfer-pricing-differences/> (stating Canada Revenue Agency has increased its emphasis on transfer pricing audits).

⁶⁰ Income Tax Treaty, *supra* note 3, art. XXVI.

⁶¹ See generally Meyer & Outman, *supra* note 47 (“When a tax treaty exists, taxpayers have generally opted for the bilateral APA because it provides assurance that economic double taxation will not occur”).

IRS in revenue procedure 2006-54,⁶² and Canada has something very similar to this.⁶³

In addition to the success rate for the competent authority process being rather high, the cost is really very minimal. There is no fee to actually file, whereas with the APA, there is a fee of \$50,000 in the United States,⁶⁴ and \$22,000 for smaller agreements.⁶⁵ On the Canada side, it is \$5,000 for small agreements⁶⁶ and approximately \$25,000 for travel expenses.⁶⁷

We also have something in the United States where a company can go in to appeals after it has had an audit, and appeals will put the case on hold and work with competent authority to resolve the case.

The final provision, the arbitration provision, was added to the Canada-United States Treaty just a few years ago. Contained on this slide is the actual provision.⁶⁸

As an aside, the head of competent authority is Patricia Spice in Canada⁶⁹ and, just recently, Mike Danolack became the head in the United States.⁷⁰

The IRS and CRA have not come together to set out specifically how this provision will work. However, both sides have said they hope that they never have to use the provision. Nevertheless, this provision has been in place for approximately two years—I believe the two-year mark will be on December 15, 2010.⁷¹ There could be cases that would not be settled by De-

⁶² Rev. Proc. 2006-54, 2006-49 I.R.B. 1035.

⁶³ CAN. REVENUE AGENCY, INCOME TAX INFORMATION CIRCULAR 71-17R5, GUIDANCE ON COMPETENT AUTHORITY ASSISTANCE UNDER CANADA'S TAX CONVENTIONS (2005), available at <http://www.cra-arc.gc.ca/E/pub/tp/ic71-17r5/ic71-17r5-e.pdf>.

⁶⁴ Wrappe & Chung, *supra* note 51, at 41.

⁶⁵ *Id.*

⁶⁶ CAN. REVENUE AGENCY, INFO. CIR. 94-4R, ADVANCE PRICING AGREEMENTS FOR SMALL BUSINESSES (2005), available at <http://www.cra-arc.gc.ca/E/pub/tp/ic94-4rstr/ic94-4rstr-e.pdf>.

⁶⁷ See *id.* (“Under the traditional APA Program, the taxpayer agrees to cover CRA expenses for APA-related travel.”); see also ERNST & YOUNG, TRANSFER PRICING GLOBAL REFERENCE GUIDE 23 (2010), available at http://www.ey.com/US/en/Services/Tax/Financial-Executives-International-Washington-Policy-Conference_September-2010 (click on “International Tax” drop down; then follow “Transfer Pricing Global Reference Guide: February 2010” hyperlink) (“The CRA charges taxpayers only travel costs it incurs in the completion of an APA.”).

⁶⁸ E. Miller Williams, Presentation at the 2010 Canada-United States Law Institute Henry T. King, Jr. Annual Conference: The United States-Canada Tax Regime: Advance Pricing Agreement, Competent Authority Resolution and Arbitration 27 (2010), available at http://cusli.org/conferences/annual/annual_2010/presentations/Saturday%20Session%201%20-%20Williams.pdf.

⁶⁹ CAN. REVENUE AGENCY, MUTUAL AGREEMENT PROCEDURE PROGRAM REPORT 24 (2008), available at http://www.cra-arc.gc.ca/tx/nrdsnts/cmp/mp_rprt_2007-2008-eng.pdf.

⁷⁰ Press Release, Internal Revenue Service, IRS Names Danilack Deputy Commissioner (Jan. 20, 2010), available at <http://www.irs.gov/newsroom/article/0,,id=218521,00.html>.

⁷¹ See Protocol Amending the Convention Between the United States and Canada with Respect to Taxes on Income and on Capital, U.S.-Can., Sept. 21, 2007, S. Treaty Doc. No.

ember 15, at which time this provision could come into play. It is still unclear, however, whether it was going to be allowed for cases filed in the past versus cases going forward.

I appreciate your time, and I will turn it over to Jeff. But we will probably take a few minutes at the end for questions. I will be happy to answer any questions. Thank you.

CANADIAN SPEAKER

*Jeffrey Shafer**

MR. SHAFER: Thank you very much for the opportunity to speak to you this morning, and thank you all for showing up. I know showing up for a discussion about tax issues at 9:00 a.m. on a Saturday morning is difficult for all of us, and the effort is certainly appreciated.

I am hoping to cover in the next couple of minutes an update on certain developments in the Canada-United States cross border tax area, specifically some updates on the Canada-United States Tax Treaty. Time permitting, I would also like to take a few minutes to discuss some changes recently announced in the Canadian budget on March 4th. These changes announced in the budget are applicable broadly to Canada's international tax regime, but given our close relationship with the United States, I think they have particular importance for United States residents.

In respect of tax treaties, the issue at the highest level is that each country's tax laws apply on a scope far beyond the borders of that country. As Miller mentioned, the objective of planning by taxpayers is typically to minimize tax but, most importantly, to eliminate double taxation of the same amounts in more than one jurisdiction. To accomplish this, countries negoti-

110-15 [hereinafter Amended Protocol].

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ate bilateral tax treaties and allocate among themselves the jurisdiction to tax certain items of profit or income in various circumstances.

Both Canada and the United States have broad ranging networks of tax treaties with countries around the world,⁷² but, at least from the Canadian perspective, the Canada-United States Tax Treaty⁷³ is a little special. It has some unique provisions in the treaty that are there, I think, primarily in recognition of our unique relationship and the volume of business that crosses our border.

The United States generally develops a “technical explanation” to explain the Internal Revenue Service’s (IRS) or the negotiator’s position on the intended meaning behind a treaty. In the case of the United States-Canada Tax Treaty, the Canadian Government participated to a certain extent in the development of that technical explanation, and then formally announced its approval of the final draft of the technical explanation. This is a very helpful step for people like me because it permits us in Canada to have more authoritative recourse to the technical explanation in terms of explaining the provisions of the treaty.

The Canada-United States Treaty was last amended by the Fifth Protocol.⁷⁴ The Fifth Protocol was announced in September 2007.⁷⁵ It only came into effect in December 2008,⁷⁶ and certain of its provisions have been phased in over time, with some of the most significant provisions coming into force as recently as January 1, 2010.⁷⁷ As these provisions come into force, the market practice is evolving because some of these provisions are quite unique. As practitioners and the governments alike are forced to grapple with these new provisions, we are all discovering technicalities and applications of these provisions to certain circumstances that may not have been apparent on first review. Now we are all having to cope with these developments.

Miller adequately covered the mandatory arbitration provision in the treaty, so I do not propose to spend any additional time on that. I will try not to get into too technical a discussion on these provisions. I am hoping to discuss the provisions in the context of an observation that the Canada-United

⁷² See generally Dennis D. Curtin, *Exchange of Information Under the United States Income Tax Treaties*, 12 BROOK. J. INT’L L. 35, 40 (1986) (discussing the proliferation of income tax treaties globally).

⁷³ Income Tax Treaty, *supra* note 3.

⁷⁴ See Amended Protocol, *supra* note 71.

⁷⁵ *Id.* at 38.

⁷⁶ See Blake, Cassels & Graydon LLP, *Fifth Protocol to Canada–U.S. Tax Treaty Enters into Force*, Blakes Bulletin: Tax, Dec. 2008, at 1, available at http://www.blakes.com/english/legal_updates/tax/december_2008/US_Protocol_Effective_Dates_Handout_Dec%202008.pdf.

⁷⁷ See Amended Protocol, *supra* note 71, at art. 27(2)-(3).

States Tax Treaty is an interesting example of the governments coming together to try and map out a border between the two legal (tax) regimes. This is good, because the two countries' regulations would otherwise overlap and subject residents of each country to double taxation.

The Treaty, as we are discovering with some of these new provisions, is also a cautionary tale, or at least a good opportunity for a lesson, on the difficulty of establishing this kind of border between two legal regimes that not only have different rules, but in certain cases, have different fundamental vocabulary. That is one of the issues we have to deal with now as we seek to implement and apply some of the new provisions introduced in the Fifth Protocol.

One of the very welcome changes in the new treaty was the elimination of withholding tax on most interest payments (see new Article XI of the Treaty, especially paragraph 1).⁷⁸ As a result, or in anticipation of the release of the United States Treaty, Canada amended its domestic tax law to eliminate withholding tax on interest paid to arm's length parties as of January 1, 2008.⁷⁹ For these purposes, arm's length refers to the relationship between the parties being arm's length, rather than referring to the terms and conditions of the debt or the interest in question.

One of the special features of the new Canada-United States Treaty, which is unique in the Canadian context, is the elimination of withholding tax on interest paid to persons *not* dealing at arm's length, provided the recipient is entitled to the benefits of the Treaty. This elimination of withholding tax on interest paid to non-arm's length persons is phased in over time. Related party interest, prior to the amendment of the treaty, would have been subject to a ten percent withholding tax rate. Under the revised rules, the first phase covers the calendar year 2008, for which the rate was decreased to seven percent;⁸⁰ in the second phase in 2009, the withholding tax rate decreased to four percent;⁸¹ and in 2010, assuming one meets the requirements, there will be zero-percent withholding.⁸² One cautionary point: there is still withholding tax on certain kinds of participating interest to be wary of.

The next innovation in the new Treaty is the introduction of provisions dealing with fiscally transparent entities. The best and most prominent example of a fiscally transparent entity being United States limited liability companies (LLCs). The issue is that most LLCs, which are either disregard-

⁷⁸ Jeffrey L. Rubinger, *New U.S.-Canada Treaty Protocol Will Affect Both Inbound and Outbound Investments*, 108 J. TAX. 173, 173 (2008).

⁷⁹ *Summary of Federal Tax Relief for 2008 and 2009*, DEP'T FIN. CAN., http://www.fin.gc.ca/n08/08-115_2-eng.asp (last modified Dec. 31, 2008).

⁸⁰ Rubinger, *supra* note 78, at 178.

⁸¹ *Id.*

⁸² *Id.*

ed or treated as partnerships for United States tax law,⁸³ have traditionally not been considered to be a resident to the United States for purposes of the Treaty by the Canadian tax authorities. The reason for this is that residence requires a person to be subject to tax in that jurisdiction effectively on the most comprehensive basis known to the tax law of that jurisdiction, and the position of the Canadian tax authorities has always been that a disregarded LLC or one taxed as a partnership is not subject to tax itself at all. All of its income is taxed in the hands of its members. However, because the LLC has a separate legal identity and is regarded legally as a corporation for Canadian purposes, it is still the visible taxpayer to the Canadian system, and by virtue of not paying tax itself, the Canadian government has taken the position that it was not a resident of the United States for purposes of the Treaty. Therefore, historically the Canadian tax authorities have generally refused to acknowledge the entitlement of transparent or disregarded LLCs to benefits under the Treaty, including reduced withholding tax rates on certain kinds of payments.

Interestingly, within the last couple of days, the first case dealing with this issue came before the Tax Court of Canada. The decision, I believe it is *TD Securities (USA) LLC v. The Queen*,⁸⁴ was released a few days before this conference began, and the Court gave a favorable holding for the taxpayer, which is somewhat ironic now that the Treaty has been amended. The court did conclude that it was inconsistent and unreasonable for the Canadian authorities to take the position that an LLC carrying on business in Canada was not really entitled to the reduced rate of branch tax that is available to United States residents.⁸⁵ The court came to this conclusion on the basis that having all of the LLC's income fully and comprehensively taxed in the United States in the hands of its sole member, a United States resident, was sufficient to satisfy the definition of "resident" in the Treaty. It remains to be seen, though, whether that decision will be appealed and how that decision will measure with the new provisions of the Treaty.⁸⁶

The advertised solution to this issue when the protocol amending the Treaty was released was that "treaty benefits would be extended to LLCs." That is not exactly what has happened.

⁸³ *Id.* at 174.

⁸⁴ *TD Securities (USA) LLC v. The Queen*, 2010 TCC 186 (Can.).

⁸⁵ *Id.*

⁸⁶ The Canadian government has since announced that it will not appeal this decision, and the deadline to file an appeal has since lapsed. Ken Snider & Janice Vohrah, *TD Securities (USA) LLC v. The Queen – Crown Does Not Seek Appeal*, CASSELS BROCK (May 14, 2010), http://www.casselsbrock.com/CBNewsletter/_i_TD_Securities_USA_LLC_v_The_Queen_i_Crown_Does_Not_Seek_Appeal.

The new rule, which is in paragraph 6 of Article IV,⁸⁷ provides a look-through of fiscally-transparent entities. It provides (from the perspective of payments to a United States LLC) that notwithstanding that an LLC in Canada is the visible taxpayer, amounts of income or gain that are derived by an LLC (or other fiscally transparent entity) will be considered to be derived by a resident of the United States to the extent that a resident of the United States derives such amounts through the LLC or fiscally transparent entity, and the treatment to the resident is the same under the laws of the United States as it would be had the resident received that item of income or gain directly. The issue of what constitutes the “same treatment” is the subject of some debate.

Unfortunately, this is not a complete solution because the LLC would only be entitled to Treaty benefits to the extent the members of the LLC are United States residents that qualify for benefits under the Treaty.⁸⁸ To the extent that a Cayman Corporation,⁸⁹ or a non-qualifying United States resident, has an ownership interest in an LLC, payments of interest, dividends, or royalties to the LLC will still be subject to the full twenty-five percent statutory withholding tax rate in Canada.⁹⁰ Similarly, to the extent of any non-United States ownership, the LLC would not be entitled to the Treaty benefits available to it if it is carrying on business in Canada.

Some of the issues that have arisen with this rule involve deemed payments. Most deemed payments under the Canada-United States Tax Treaty, such as deemed dividends that arise out of a Canadian corporation, are treated in the same manner as the payments to which they are assimilated. A deemed dividend is treated as if it were a dividend. However, given the specific language in Article IV(6),⁹¹ the Canadian government has recently released a technical interpretation providing that an LLC—such as the one in this example—would not be entitled to benefits of the Treaty with respect to certain deemed payments made by a Canadian company.⁹² According to the interpretation, one of the criteria that must be met for Article IV(6) to apply is that there must be an item of gain or income recognized in the United States,⁹³ and that simply is not the case for many deemed payments that arise under domestic Canadian tax law.

So that is one of the areas where there is still a fair amount of uncertainty, and the hope that we all had—that the changes in the Treaty would simplify

⁸⁷ See Amended Protocol, *supra* note 71, art. 2.

⁸⁸ Rubinger, *supra* note 78, at 176.

⁸⁹ Cayman Corporation is a fictional entity used only for illustrative purposes.

⁹⁰ Rubinger, *supra* note 78, at 176.

⁹¹ CAN. REVENUE AGENCY, INCOME TAX TECHNICAL NEWS, NO. 41, at 13-16 (2009), <http://www.cra-arc.gc.ca/E/pub/tp/itnews-41/itnews-41-e.pdf>.

⁹² *Id.*

⁹³ *Id.*

and permit the use of LLCs in cross-border business arrangements—has not quite come true, but we will certainly see how that develops.

The second category of new rules that were brought into the Treaty includes the so-called anti-hybrid rules.⁹⁴ The anti-hybrid rules were introduced primarily to address certain financing structures considered aggressive by the respective governments, known as “double dip” financing structures. These structures provided either a deduction of the same interest in both jurisdictions, or a deduction in one jurisdiction without any recognition of income in the other. From a tax policy perspective, we can understand why the two governments may have decided not to permit this kind of tax planning. The issue, again, is the implementation in the Treaty of the anti-hybrid rules and the scope to which they extend. These rules appear to catch many common business structures even though these structures were likely not the intended target of the drafters of these provisions.

The anti-hybrid rules have two branches. The first is in Article IV(7)(a), and it applies to an entity that is fiscally transparent in the source state, but not in the residence state.⁹⁵ For example, consider a Canadian partnership “Canadian LP” with a United States corporation, “USCo” as a partner. Canadian LP is treated as a partnership for Canadian purposes, and is therefore “fiscally transparent.” However, as I understand, Canadian LP can “check the box,” that is, file an election, to be taxed as a corporation for United States tax purposes. To the extent USCo derives amounts of income through Canadian LP, Canada would otherwise treat this as USCo deriving income directly and would therefore extend benefits of the Treaty.⁹⁶ But Article IV(7)(a) provides that Canada will not extend treaty benefits to those payments. There has been a general level of acknowledgment that this rule is well targeted at these kinds of entities, which were used in the financing structures that are understood to have been the motivation behind the anti-hybrid rules.

The second branch of the anti-hybrid rules contained in Article IV(7)(b)⁹⁷ was unexpected, and proves a little more difficult in its application. Article IV(7)(b) applies to entities that in the source state are opaque but are treated in the residence state as fiscally transparent. In a simple example, a company called Canada ULC is an unlimited liability company in Canada. Canada treats it as any other corporation: a visible taxpayer. However, unlimited liability corporations (ULCs) may be entitled to be treated as disregarded entities (or transparent partnerships) for United States tax purposes.

⁹⁴ See Amended Protocol, *supra* note 71, art. 2.

⁹⁵ Rubinger, *supra* note 78, at 175.

⁹⁶ *Id.*

⁹⁷ See Amended Protocol, *supra* note 71, art. 2.

Now consider in this example a United States resident corporation, USCo, which is otherwise entitled to the benefits of the Treaty. Article IV(7)(b) provides that if USCo derives amounts of income or gain through an entity such as Canadian ULC that is opaque in the source state (Canada) but transparent in the residence state (of USCo – the United States), and if the treatment of those items of income or profit is different in the residence state (United States) by virtue of the entity being treated as fiscally transparent under United States tax law, treaty benefits will not be available with respect to those items of income or gain.⁹⁸

The justification behind this rule is easy to understand: financing structures took advantage of the differences between these entities in each of the two states in order to achieve tax benefits. The problem with the way this rule is drafted, however, is that it is extremely broad and applies to all kinds of payments, not just deductible payments that were the focus of these structures.

The example of Canadian ULC owned by USCo is an example of a very simple structure that has been employed by many United States investors in Canada. The reason is that there are advantages to making an investment through a legal entity that is disregarded for United States tax purposes. Some of the benefits accruing to a United States investor would be easier consolidation for United States tax purposes, and better availability of foreign tax credits to the extent that Canadian tax is payable on items of income earned by Canadian ULC. The problem is that it is a very simple, arguably non-aggressive structure, and yet, it is caught by the words of IV(7)(b).⁹⁹ We have heard from the government that this result was unintended, but the Canadian tax authorities agree that this is the result of the words of the Treaty, and therefore the final word for the time being. Unfortunately, the technical explanation that was released to the Treaty does not provide for any relief in this regard.

To the extent the Treaty benefits are denied, payments across the border would be subject to the full statutory withholding rates in Canada of twenty-five percent.¹⁰⁰ There have been certain structural solutions suggested in light of this rule, and the Canadian Revenue Agency (CRA) has provided a few advanced income tax rulings on some of these structures, including one for dividends—I will not get into the technicalities of that. Very generally, these solutions involve the triggering of a deemed dividend, which will be subject to Canadian non-resident withholding tax. However, this will not be a problem under the anti-hybrid rules because the deemed dividend is generally disregarded in the United States, and so the treatment is the same regard-

⁹⁸ Rubinger, *supra* note 78, at 176.

⁹⁹ *Id.*

¹⁰⁰ *Id.* at 174.

less of whether the Canadian ULC is regarded or disregarded. The deemed dividend is therefore entitled to the reduced treaty withholding tax rates. Following this, there is a method by which capital can then be returned from the Canadian ULC free of withholding tax to economically achieve the same result as a dividend at the lower going tax rate.

The CRA has provided a few advanced income tax rulings on this structure.¹⁰¹ Of course, the CRA has reserved the right to attack any particular structure to the extent they believe it is being used in an abusive way, or that it does not fit within the spirit of the provision. There are also technical issues that may prevent the use of this structure where the recipient of payments or deemed payments is a disregarded United States entity, such as an LLC.

More difficult is the prospect of deductible payments where there is more scope for mischief, or at least perceived mischief. For example, consider the hypothetical entities just discussed, and a payment to USCo of interest from the Canadian ULC. Assuming that the Canadian domestic requirements were met, the interest would be deductible to Canadian ULC in computing its income in Canada. But by virtue of the disregarded status of Canadian ULC for U.S. tax purposes, that interest would not be recognized as income in the United States. While it would not be a double dip, you would have a deduction in Canada with no corresponding recognition of income in the United States. The Canada Revenue Agency has indicated that it is not inclined to rule favorably on any structure that has that result, because they feel that Canada should have the entitlement to tax amounts paid to U.S. residents where there is no corresponding tax (income recognition) in the United States.¹⁰²

There may be certain structural solutions involving an interest payment being made to a different entity in a consolidated United States group where the item of income would be recognized in the United States as a payment between two different United States entities (with or without actually attracting a net tax liability in the consolidated group). The CRA has indicated that it might be willing to rule favorably in those kinds of circumstances, but this is still on a case-by-case basis. Planning in advance to use such a structure

¹⁰¹ See Kathleen Penny et al., *Technical Explanation Offers No Relief for U.S. Residents with Interests in ULCs*, BLAKES (July 18, 2008), available at <http://www.blakes.com/english/view.asp?id=2438> (“Practical details regarding the information that will have to be provided by the LLC to establish the members’ Treaty status was not included in the TE [technical explanation]. The TE indicates that the CRA will provide guidance in this regard.”).

¹⁰² See *id.* (“From a tax policy perspective, it is perhaps understandable that treaty relief from withholding tax should not be available in a case where the recipient of the payment is not subject to tax on the payment in the recipient’s country of residence and the payment is deductible in computing the income of the hybrid entity in the source country.”).

should be done with caution, and seeking an advance ruling from the CRA may be appropriate.

The last category of innovation that I wanted to address in the Canada-United States Tax Treaty is the introduction from the Canadian side of reciprocal limitation on benefits (LOB) rules.¹⁰³ The LOB rules have been in place from the United States perspective since the 1995 protocol to the Treaty,¹⁰⁴ but this is new to Canada, and it is the only treaty of Canada that contains comprehensive limitation on benefits rules.¹⁰⁵ The Canadian authorities have indicated that the introduction of limitation on benefits provisions will not form part of their treaty negotiation policy in the near future.

Generally speaking, the LOB rules are designed to prevent treaty shopping. They are designed to prevent the structuring of affairs whereby entities are situated in a jurisdiction solely for the purpose of claiming the benefits of a tax treaty in circumstances where, in the view of the governments, those benefits are not properly available.

The rules provide for several different levels of entitlement to benefits. The most general is the broad entitlement to benefits of so-called “qualifying persons,” which have a number of different categories, including public companies, individuals, and certain private entities that are owned by qualifying persons.

There may be certain other requirements for private entities, including a “base erosion” test to ensure that the majority of the entity’s deductible expenses are not being streamed to entities that are themselves not entitled to benefits under the treaty. There are also alternative methods of qualifying from a more limited scope of benefits under the Treaty. The active conduct of a connected trade or business test will permit a resident that is not otherwise a qualifying person to claim benefits on items of gain or income that arise in connection with the active conduct of a trader business that is conducted substantially on both sides of the border.

Benefits are also available under “derivative benefits” rules that extend only to dividends, interest, and royalties in circumstances where it can be demonstrated that, although the United States resident is not a qualifying person, the ultimate owner of the United States resident would otherwise be entitled to equal or better benefits under the treaty of its own jurisdiction with Canada.¹⁰⁶ The idea behind this rule is that if these requirements are met, it is reasonable to presume that the structuring of the United States resident was not specifically for the purpose of accessing treaty benefits.

¹⁰³ Rubinger, *supra* note 78, at 173.

¹⁰⁴ *Id.* at 181 n.27.

¹⁰⁵ *Id.*

¹⁰⁶ *See generally* Rubinger, *supra* note 78, at 181 n.28 (discussing the rules surrounding Canadian LOBs).

Finally, it is possible to make an application to the competent authority where none of the technical rules apply. A taxpayer can make an application to the competent authority where they can demonstrate that it is appropriate that treaty benefits be extended and where it can be demonstrated that a particular entity was not situated in a jurisdiction specifically for accessing the benefits of the treaty. The competent authorities will rule as to whether or not treaty benefits should be extended in a particular circumstance.

I discussed earlier that the changes introduced by the Fifth Protocol are an example of the difficulty of trying to define the legal border between two very different regimes. The LOB provisions are one of the key areas in which difficulties arise as a result of differences in vocabulary.

The LOB rules have been in the Treaty in substantially the same form they are today since 1995,¹⁰⁷ but because they only applied from the United States perspective, they were drafted initially entirely using United States concepts and vocabulary. The provisions have been amended slightly,¹⁰⁸ but not substantially, as a result of the bilateral application, but the problem we are facing in Canada is that many of the words that are used in these rules are words that are known for purposes of United States tax law but that simply have no particular meaning in Canadian tax law.

Certainly, some comfort can be had and some help is provided by the technical explanation that was published by the United States as to the interpretation of these rules.¹⁰⁹ The Canadian government has also confirmed that, beyond the technical explanation of this particular treaty, we can look to the United States model for technical explanation, which is a far more substantive document that relates to the United States Model Tax Treaty and the meaning of the provisions in the model treaty. However, we are still struggling with this.

One example, which ties into my last topic of the domestic Canadian developments, is that historically Canada has taxed non-residents on the disposition of private Canadian company shares, even where those shares do not represent an interest in Canadian real property. That is a difference in the scope of the Canadian tax rules for most countries, and certainly from the rules that are in almost all of our bilateral tax treaties.

With this idea in mind, consider the levels of qualifications for benefits under the LOB rules. It may be difficult to ascertain with certainty that an entity is a “qualifying person” because of the level of detail that is required in

¹⁰⁷ Rubinger, *supra* note 78, at 181 n.27.

¹⁰⁸ See Amended Protocol, *supra* note 71, art. 25.

¹⁰⁹ DEP'T OF THE TREASURY, TECHNICAL EXPLANATION OF THE PROTOCOL AMENDING THE CONVENTION BETWEEN THE UNITED STATES AND CANADA WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL (2008), available at <http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/tecanada08.pdf>.

terms of looking through the organization, from the top of the chain of ownership and at all of the owners in a structure, as well as in circumstances where the base erosion test applies on a year-by-year basis to the deductible expenses of the entity.¹¹⁰

Many taxpayers in practice rely on the active conduct of a trade or business test in order to get comfortable with their entitlement to treaty benefits. However, the way the rule is drafted, it is not entirely clear how it is meant to interact with the domestic Canadian tax law. For example, it certainly was not clear when the Fifth Protocol was first announced that the gain on the disposition of shares of a Canadian company would be adequately connected to the conduct of an active business in order to qualify under this rule. In fact, in Canada, we have typically viewed the disposition of a business and the “capital gain” on the shares of a corporation to be distinct from the income of that business. There was therefore much discomfort when the rule was first announced.

The CRA has since released some much appreciated guidance on this topic. The CRA has stated that to the extent that a gain can be attributed to the value of a connected business, a sufficient connection will have been established for this purpose, and the CRA will apply the active conduct trader business test to permit treaty benefits in respect to such a gain.¹¹¹

But that is just one example. There are others where the language that was developed initially in the United States context provides difficulty for us in Canada in terms of its application.

The final topic that I wanted to cover briefly is some of the changes announced in the Canadian budget.

The changes to Canadian tax law that were announced will affect the degree to which Canada taxes gains in the hands of non-residents on the disposition of certain Canadian property.¹¹² The changes will help to simplify the compliance burden on non-residents, even if it does not have a tremendous effect on the ultimate tax liability, which would likely have been in a very similar position if the non-resident was entitled to the benefits of a tax treaty with Canada.

Those are some of the specific items I wanted to cover. As I alluded to this earlier, Canada has historically domestically sought to tax non-residents on the disposition of “taxable Canadian property,” which included shares of

¹¹⁰ See generally Rubinger, *supra* note 78, at 181 n.28 (discussing the rules surrounding Canadian LOBs).

¹¹¹ *Id.*

¹¹² Jeffrey Trossman & Paul Stepak, *2010 Canadian Federal Budget Significantly Narrows Taxation of Non-Residents Investing in Canadian Equity*, BLAKES BULLETIN: PRIVATE EQUITY, March 2010, at 1, available at http://www.blakes.com/english/legal_updates/private_equity/mar_2010/PE.pdf.

private Canadian companies, among other things, even if they did not represent an interest in Canadian real property. I understand that to be different from most countries, and certainly different from the scope of taxation permitted by the majority of Canada's income tax treaties. Most such treaties provide an exemption from tax on gains except to the extent that the gain is derived from the real property.

However, there remain domestic compliance obligations, stemming from Section 116 of the Income Tax Act, requiring a disposing non-resident to obtain a certificate of compliance, even if there is no liability for tax.¹¹³ These are quite onerous obligations that still apply in these circumstances. As a result, it has created somewhat of a disincentive to foreign investment in Canada and has been at least a nuisance to many a taxpayer.

Section 116 of the Income Tax Act requires the obtaining of a certificate of compliance by a non-resident disposing of taxable Canadian property.¹¹⁴ If the certificate is not provided to the purchaser, the purchaser would typically withhold twenty-five percent of the purchase price and remit it to the government.¹¹⁵ In recent years, it has not been uncommon to take as long as a year to obtain a certificate, depending on the circumstances. The process also requires taxpayers to provide to the Canadian tax authorities a lot of detailed information that is frequently difficult to obtain. During the waiting period for obtaining a certificate, vendors would have twenty-five percent of their proceeds tied up in escrow.

Thankfully, in the budget announced on March 4, 2010, Canada has proposed a change to the definition of taxable Canadian property, which narrows the scope of this regime.¹¹⁶

Under the new definition, taxable Canadian property will only consist of Canadian real property, property used in a Canadian business, certain insurance and financial property, and shares of a corporation or interests in trusts and partnerships that are real property interests, or interests that derive more than fifty percent of their value from real property situated in Canada.¹¹⁷ That test is still applied on a sixty-month look-back basis. Shares will be taxable Canadian property if they derive their value more than fifty percent from Canadian real property at any time within the previous five years. So, there is still some investigation to be done, and the rules, as currently drafted, do not provide for a due diligence defense. The extent to which reliance will be placed on these rules and practice remains to be seen, but the intent behind

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 2; JAMES M. FLAHERTY, MINISTER OF FIN., BUDGET 2010: LEADING THE WAY ON JOBS AND GROWTH 330 (2010), available at <http://www.budget.gc.ca/2010/pdf/budget-planbudgetaire-eng.pdf>. These changes have since been enacted into law.

¹¹⁷ Trossman & Stepak, *supra* note 112, at 2.

the rules has been made clear by the government, and it is a very positive development in terms of investment in Canada.

The final change that I would just touch on extremely briefly is that Canada has been proposing two regimes of anti-avoidance rules for some time—rules that are proposed to be retroactive in their application back to the date of original announcement in 2006 or earlier. These rules are the so-called non-resident trust and foreign investment entity (FIE) rules.¹¹⁸ The March 4 budget announced that the FIE proposals are being withdrawn, and the existing rules in the income tax act will be applied in their stead with some minor revisions.¹¹⁹ The non-resident trust rules are being amended to provide greater certainty and clearer exemptions for commercial trusts, which was one of the key areas of difficulty with the previous rules and their very broad scope of application.

Thank you again for the opportunity to speak, and I welcome any questions.

DISCUSSION FOLLOWING THE REMARKS OF E. MILLER WILLIAMS AND JEFFREY SHAFER

MR. GROETZINGER: We have time for just one or two questions.

MR. FUNG: What is the status with respect to any recent changes to a permanent establishment situation, and how are the sales taxes being imposed by states being treated in the United States-Canada Treaty?

MR. SHAFER: I can start from the Canadian perspective. There were a couple of changes announced to the permanent establishment article in the Canada-United States Tax Treaty in the context of the recent protocol.¹²⁰ The biggest of those changes was the so-called services permanent establishment rule in paragraph 9 of Article V. This rule provides that an enterprise that does not otherwise have a permit establishment within a state under the typical rules may be deemed to have a permanent establishment if it provides services in that state to a customer in the context of the same or series of connected projects for 183 days or more in any rolling twelve-month period.

That is a very atypical provision in most treaties. I understand the United States was highly resistant to this change. The change was sought by Canada primarily in response to a decision in Canada that was decided in favor of the taxpayer and that held that a taxpayer in Canada that was providing services for an extended period of time did not have a permanent establishment.¹²¹

¹¹⁸ FLAHERTY, *supra* note 116, at 100.

¹¹⁹ *Id.*

¹²⁰ Amended Protocol, *supra* note 71, art. 3.

¹²¹ *The Queen v. William A. Dudney*, 2000 DTC 6169 (FCA) (Can.).

They were using space available at their customers' locations, and the court decided that that space was not sufficiently at their disposition to constitute a place of business of that nonresident taxpayer.

There have been two cases decided last year in Canada dealing primarily with agency permanent establishments—*The Knights of Columbus*¹²² and *American Income Life Insurance Company*¹²³—but those two cases were also decided in favor of the taxpayer and are recent developments in the domestic Canadian context. I do not know if Miller has anything else to add.

MR. WILLIAMS: No. Other than when you do have a branch and you do have a permanent establishment, the transfer pricing rules do come into play in terms of what the pricing should be. I did not know if your question was about sales tax in states in the United States. I think that may not even be determined by the Income Tax Treaty. It seems that would really be a function of state law and whether the sales tax would apply there.

MR. SHAFER: I certainly think that is correct, with the caveat that I practice only income tax law; I am not an expert in the sales tax area, especially not in the United States.

MR. GROETZINGER: Any other questions?

MR. ROBINSON: Thank you. I have a question for Jeffrey. Back in the bad old days, one of the big double-dipping gambits was based on the different treatment of lease payments in terms of whether they were just conditional sales or not. Is there any scope for this that remains between Canada and the United States? I think there still is between Canada and certain European countries, but has that double dip been eliminated?

MR. SHAFER: I will confess that I have heard of, but am not overly familiar with those leasing structures. I know that recently the Canada Revenue Agency announced a change in its policy on so-called financing leases. They previously had more defined rules regarding how to treat such instruments. Now, the CRA takes the position—which is consistent with what they do in any other context—that they will look to the nature of the transaction and at the underlying commercial legal status of the agreement. If the incidents of ownership are actually primarily transferred by virtue of the arrangement, they will regard the arrangement as a sale. If they do not view the arrangement as tantamount to a sale, however, they will continue to treat it as a lease.

Since the introduction of the protocol in amending the Tax Treaty,¹²⁴ there certainly has been in the Canada-United States context an increase in focus on double dip structures that employ not hybrid entities—these are covered

¹²² *Knights of Columbus v. The Queen*, 2008 TCC 307 (Can.).

¹²³ *American Income Life Insurance Company v. R*, 2008 TCC 306 (Can.).

¹²⁴ Revised Protocol, *supra* note 4.

by the rules in the Treaty provisions¹²⁵—but hybrid instruments. One of the favorite instruments for this purpose is hybrid debt, which is treated as debt in Canada but by virtue of certain characteristics and/or other separate arrangements, it is treated as equity for United States purposes.

I would imagine by analogy, at least, that those opportunities would still exist in the leasing world to the extent that one would be able to establish a different treatment in the two countries.

MR. GROETZINGER: Any other questions? I had one last question for Miller. If a company goes in for an advanced pricing agreement, does that increase the risk of audit on prior years or in the future?

MR. WILLIAMS: It is not supposed to increase their risk. However, in the case they are actually going in to both tax authorities and asking for a ruling, they could go back and maybe look at preceding years.

Now, if the facts and circumstances, though, were the same, then you would really be trying to roll that back anyway. We really have not seen that to be much of a problem.

MR. GROETZINGER: Very good.

¹²⁵ *Id.*