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Eligibility for Treaty Benefits Under The Canada-U.S. Income Tax Treaty

by John Venuti, Jason Connery, Douglas Poms, and Alexey Manasuev

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SPECIAL REPORTS

Eligibility for Treaty Benefits Under the Canada-U.S. Income Tax Treaty

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John Venuti and Jason Connery are principals, Douglas Poms is a director, and Alexey Manasuev is a manager in KPMG's Washington National Tax International Corporate Services Group.

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To be entitled to benefits under income tax treaties, companies must satisfy eligibility requirements. This article includes flowcharts to help practitioners navigate the eligibility requirements of the limitation on benefits provision of the Canada-U.S. income tax treaty.[1]

Income tax treaties may exempt business income from source country income taxes and eliminate or reduce domestic withholding taxes on payments between residents of the contracting states to an applicable income tax treaty. To be entitled to benefits under an income tax treaty with the United States, companies must not only be a resident of the other contracting state, but generally must also satisfy at least one of the tests in the LOB provision, if applicable.

The flowcharts in this article focus on the eligibility of Canadian resident companies claiming benefits on income that would otherwise be subject to U.S. taxation. This article does not address the eligibility for benefits under the LOB provision of the treaty for estates, trusts, partnerships, or entities treated as fiscally transparent for U.S. or Canadian tax purposes.[2] This article is based on the treaty, the associated protocols, and the U.S. Treasury Department's technical explanation to the fifth protocol.[3]

This article is the fifth in a series of articles[4] that provides flowcharts to assist practitioners:

- in determining a company's eligibility for treaty benefits under the LOB provisions of specific U.S. income tax treaties; and

[1]Convention Between Canada and the United States of America With Respect to Taxes on Income and on Capital, signed September 26, 1980, as amended by protocols signed June 14, 1983; March 28, 1984; March 17, 1995; July 29, 1997; and September 21, 2007 (fifth protocol). (For the fifth protocol, see *Doc 2007-21595* or *2007 WTD 185-9*.)

[2]In limited instances, the flowcharts refer to provisions in the LOB provision of the treaty that apply to situations involving trusts and fiscally transparent entities.

[3]Treasury Department technical explanation of the protocol done at Chelsea on September 21, 2007, amending the Canada-U.S. income tax treaty.

[4]*See* John Venuti, Ron Dabrowski, Douglas Poms, and Alexey Manasuev, ''Eligibility for Treaty Benefits Under U.K.-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, Mar. 23, 2009, p. 1095, *Doc 2009-4590*, or *2009 WTD 56-9*; John Venuti, Jason Connery, Douglas Poms, and Alexey Manasuev, ''Eligibility for Treaty Benefits Under the Luxembourg-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, July 21, 2008, p. 285, *Doc 2008-14359*, or *2008 WTD 142-8*; John Venuti, Ron Dabrowski, Douglas Poms, and Alexey Manasuev, ''Eligibility for Treaty Benefits Under the France-U.S. Income Tax Treaty,'' *Tax Notes Int'l*, Feb. 11, 2008, p. 523, *Doc 2008-773*, or *2008 WTD 33-10*; and John Venuti and Alexey Manasuev, ''Eligibility for Zero Withholding on Dividends in the New 2006 Germany-U.S. Protocol,'' *Tax Notes Int'l*, Jan. 14, 2008, p. 181, *Doc 2007-27516*, or *2008 WTD 12-10*.

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- when applicable, in determining eligibility for a 0 percent withholding tax rate on cross-border intercompany dividend payments received by a company.

Although the flowcharts provide a comprehensive review of applicable treaty provisions, taxpayers and their tax advisers should carefully evaluate each case and determine whether the requirements of the treaty are met based on all facts and circumstances. ◆

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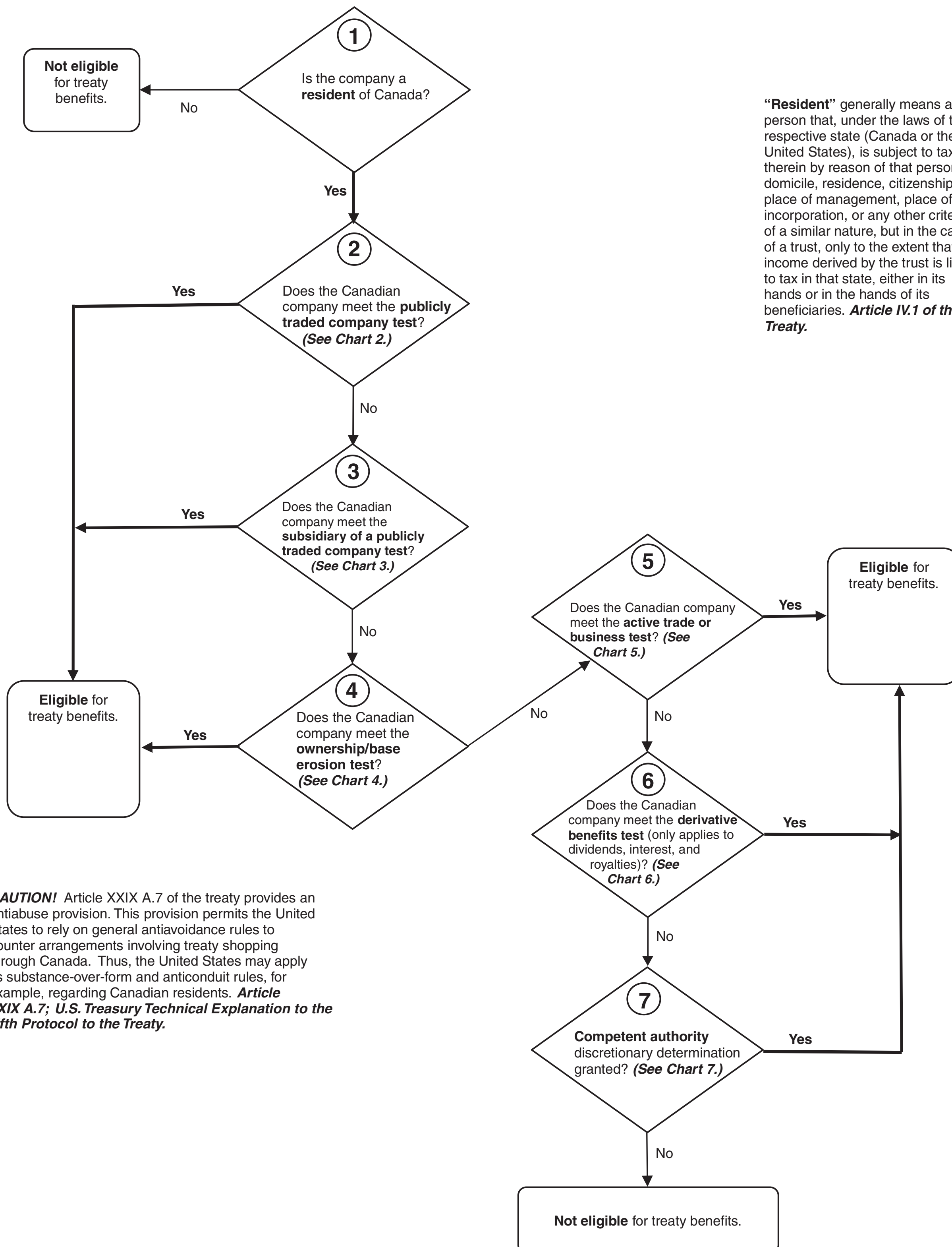

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Chart 2. Publicly Traded Company Test Under Article XXIX A.2(c) (LOB) of the Canada-U.S. Tax Treaty

"Shares" includes, in the case of a mutual insurance company, any certificate or contract entitling the holder to voting power in the corporation. In Canada, the principles that are reflected in subsection 256(8.1) of the Canadian Income Tax Act will be applied, in effect treating memberships, policies, or other interests in a corporation incorporated without share capital as representing an appropriate number of shares. ***U.S. Treasury Technical Explanation to the Fifth Protocol to the Treaty.***

"Principal class of shares" of a company means 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. If no single class of ordinary or common shares represents the majority of the aggregate voting power and value of the company, the "principal class of shares" are those classes that in the aggregate represent a majority of the aggregate voting power and value of the company. ***Article XXIX A.5(e).***

Is the Canadian company's **principal class of shares** (and any **disproportionate class of shares**) **primarily and regularly traded** on one or more **recognized stock exchanges**? ***Article XXIX A.2(c).***

No → **Not eligible** for treaty benefits. ***(Go to Chart 3.)***

Yes → **Eligible** for treaty benefits.

"Recognized stock exchange" includes:

- the NASDAQ system owned by the National Association of Securities Dealers 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;
- Canadian stock exchanges that are **"prescribed stock exchanges"** or **"designated stock exchanges"** under the Income Tax Act; and
- any other stock exchange agreed upon by the contracting states in an exchange of notes or by the competent authorities of Canada and the United States. ***Article XXIX A.5(f).***

"Prescribed stock exchanges" or **"designated stock exchanges"** include the Montreal Stock Exchange, the Toronto Stock Exchange, and Tiers 1 and 2 of the TSX Venture Exchange. ***U.S. Treasury Technical Explanation to the Fifth Protocol to the Treaty.***

The term **"disproportionate class of shares"** means any class of shares of a company resident in Canada or the United States that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments, or otherwise, in the earnings generated in the United States or Canada, respectively, by particular assets or activities of the company. ***Article XXIX A.5(b).***

"Regularly traded" is not defined in the treaty. This term will have the meaning it has under the laws of the state concerning the taxes to which the treaty applies, generally the source state (the United States in this case). In the case of the United States, this term is understood to have the meaning it has under Treas. reg. section 1.884-5(d)(4)(i)(B), relating to the branch tax provisions of the code (ignoring references to the 80 percent ownership requirement of Treas. reg. section 1.884-5(d)(4)(i)(A)). Under these regulations, a class of shares is considered to be "regularly traded" if two requirements are met: **(1)** trades in the class of shares are made in more than de minimis quantities on at least 60 days during the tax year; and **(2)** the aggregate number of shares in the class traded during the tax year is at least 10 percent of the average number of shares outstanding during the tax year; Treas. reg. section 1.884-5(d)(4)(ii) (discussing when classes of stock traded on a domestic established securities market treated as meeting trading requirement); and Treas. reg. section 1.884-5(d)(4)(iii) (discussing when closely held classes of stock not treated as meeting trading requirement are not taken into account for purposes of defining the term "regularly traded" under the treaty).

The regularly traded requirement can be met by trading on one or more recognized stock exchanges. Therefore, trading may be aggregated for purposes of this requirement. Thus, a Canadian company could satisfy the regularly traded requirement through trading, in whole or in part, on a recognized stock exchange located in the United States. Authorized but unissued shares are not considered for purposes of this test. ***U.S. Treasury Technical Explanation to the Fifth Protocol to the Treaty.***

"Primarily traded" is not defined in the treaty. This term will have the meaning it has under the laws of the state concerning the taxes to which the treaty applies, generally the source state (the United States in this case). In the case of the United States, this term is understood to have the meaning it has under Treas. reg. section 1.884-5(d)(3), relating to the branch tax provisions of the code. Accordingly, stock of a corporation is "primarily traded" if the number of shares in the company's principal class of shares that are traded during the tax year on all **recognized stock exchanges** exceeds the number of shares in the company's principal class of shares that are traded during that year on all other established securities markets.

Subject to the adoption by Canada of other definitions, the U.S. interpretation of **"regularly traded"** and **"primarily traded"** will be considered to apply, with such modifications as circumstances require, under the treaty for purposes of Canadian taxation. ***U.S. Treasury Technical Explanation to the Fifth Protocol to the Treaty.***

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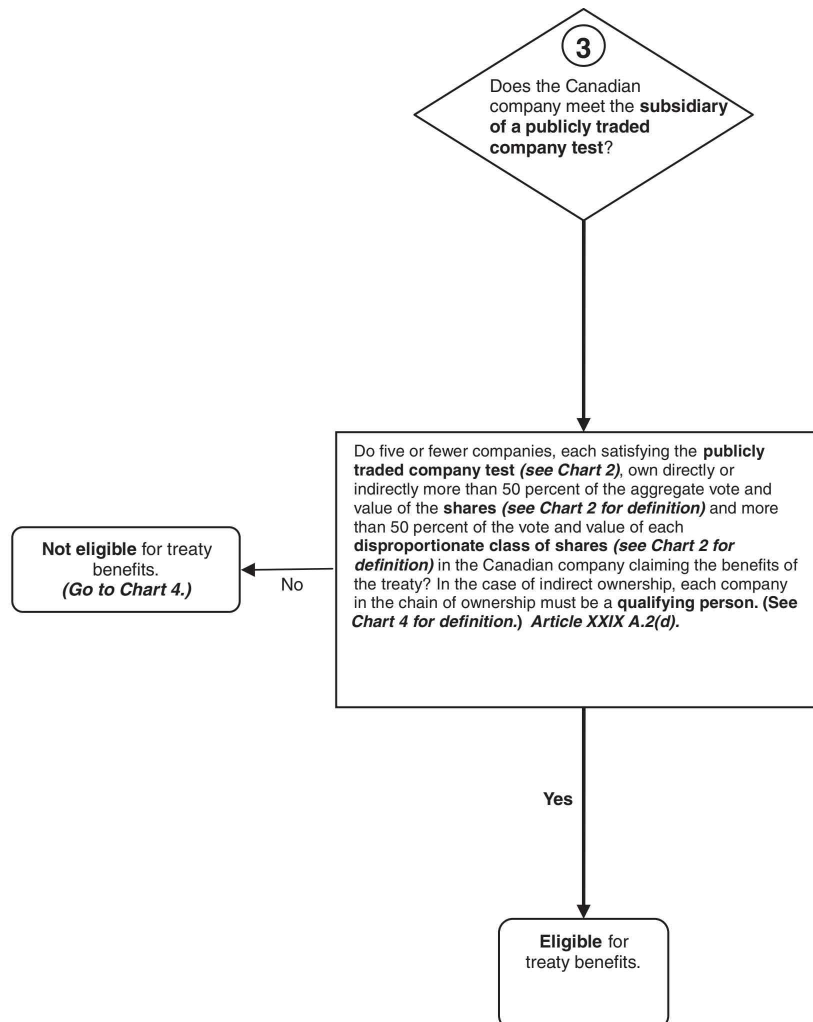
Chart 3. Subsidiary of a Publicly Traded Company Test Under Article XXIX A.2(d) (LOB) of the Canada-U.S. Tax Treaty



"Shares" and **"disproportionate class of shares"** do not include **debt substitute shares.** ***Article XXIX A.2(d).***

"Debt substitute share" means: **(1)** a share described in paragraph (e) of the definition in the Canadian Income Tax Act of "term preferred share" (see subsection 248(1) of the Canadian Income Tax Act), as it may be amended from time to time without changing the general principle thereof; and **(2)** such other type of share as may be agreed upon by the competent authorities of Canada and the United States. ***Article XXIX A.5(a); U.S. Treasury Technical Explanation to the Fifth Protocol to the Treaty.***

For purposes of this test, the Canadian company also may be owned by five or fewer trusts (and/or companies) that satisfy the **publicly traded company test** ***(see Chart 2)***. The requirements for a trust to satisfy the **publicly traded company test** ***(see Chart 2)*** are similar to those for a company. ***Article XXIX A.2(c), A.2(d), A.5(c); U.S. Treasury Technical Explanation to the Fifth Protocol to the Treaty.***

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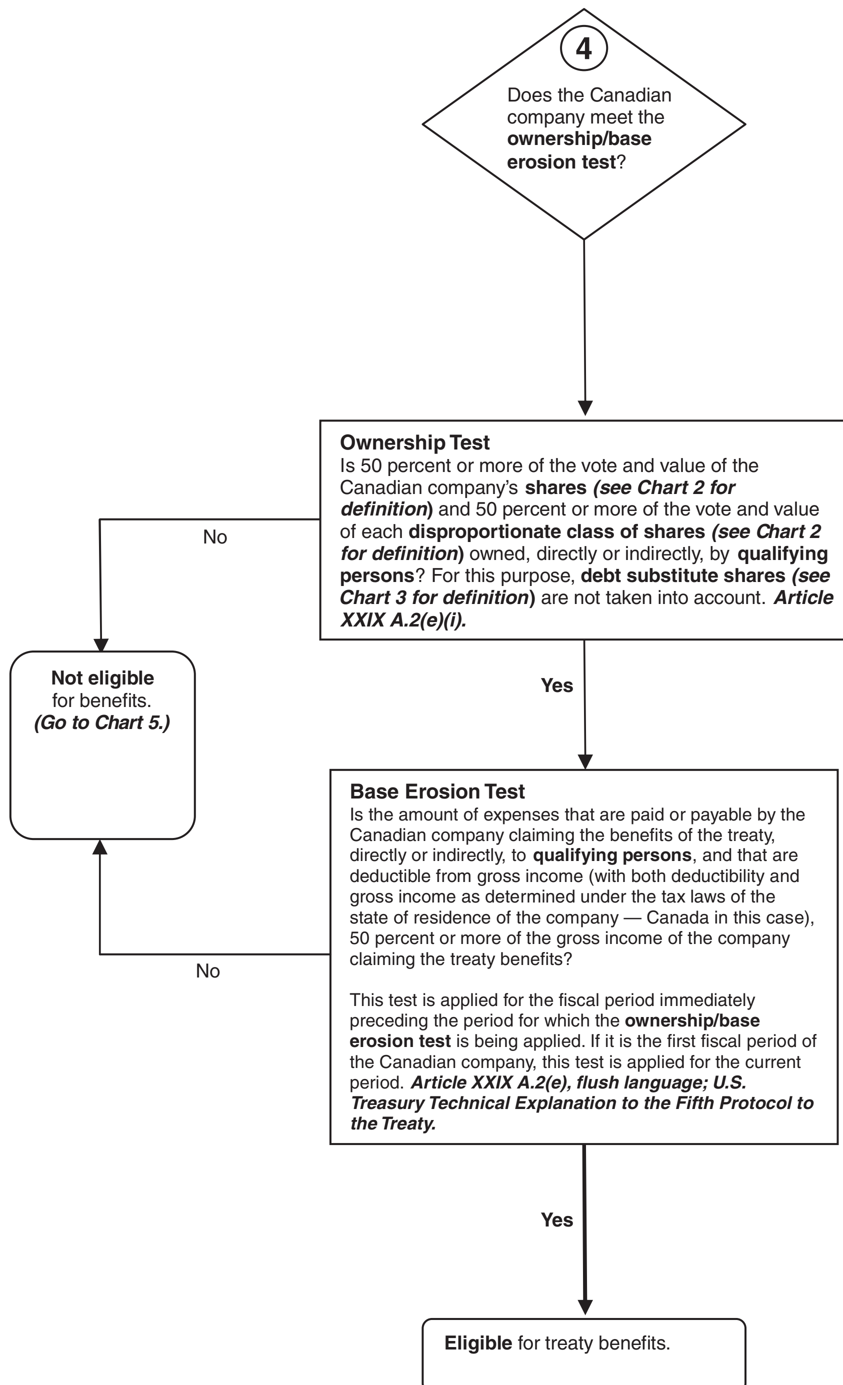
Chart 4. Ownership and Base Erosion Test Under Article XXIX A.2(e) (LOB) of the Canada-U.S. Tax Treaty



Qualifying persons include residents of Canada or the United States that are:

- natural persons resident in the United States or Canada ***(Article XXIX A.2(a))***;
- Canada or the United States, political subdivisions or local authorities thereof, and any agency or instrumentality of such government, political subdivision, or local authority ***(Article XXIX A.2(b))***;
- publicly traded companies or trusts ***(Article XXIX A.2(c))***;
- subsidiaries of publicly traded companies or trusts ***(Article XXIX A.2(d))***;
- companies meeting the ownership/base erosion test ***(Article XXIX A.2(e))***;
- certain estates ***(Article XXIX A.2(f))***;
- certain not-for-profit organizations ***(Article XXIX A.2(g))***; or
- certain exempt trusts, companies, organizations, or other arrangements ***(Article XXIX A.2(h), (i))***.

The look-through principles contained in the Article IV.6 (added by the fifth protocol) are taken into account when applying the **ownership/base erosion test.** Therefore, one "looks through" an entity that is viewed as fiscally transparent under the domestic laws of the residence state (other than entities that are resident in the source state (here, the United States)) when applying the **ownership/base erosion test.** ***U.S. Treasury Technical Explanation to the Fifth Protocol to the Treaty.***

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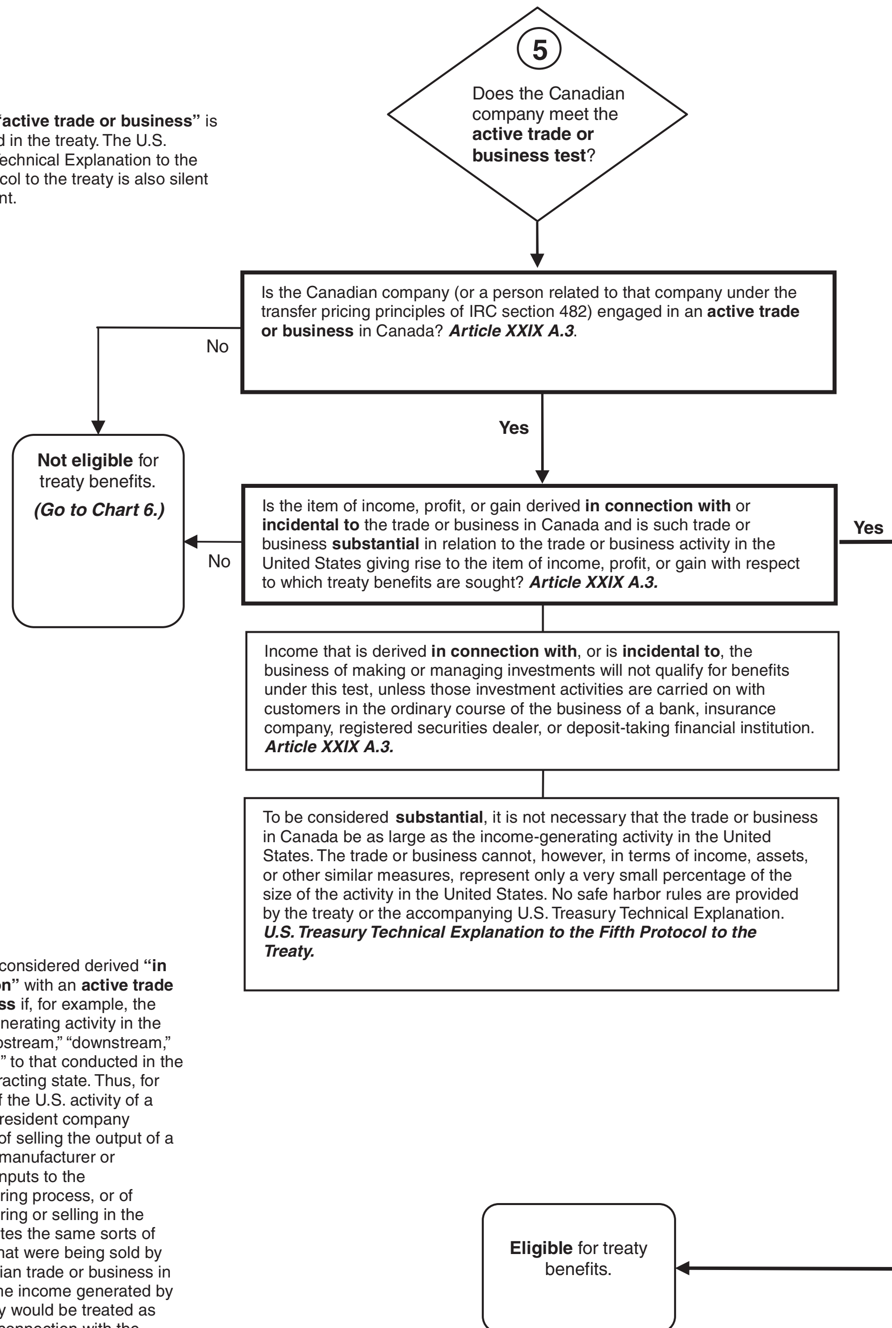
Chart 5. Active Trade or Business Test Under Article XXIX A.3 (LOB) of the Canada-U.S. Tax Treaty

(Only applies if an item of income is derived in connection with or incidental to an active trade or business in Canada)

The term **"active trade or business"** is not defined in the treaty. The U.S. Treasury Technical Explanation to the Fifth Protocol to the treaty is also silent on this point.



Income is considered derived **"in connection"** with an **active trade or business** if, for example, the income-generating activity in the state is "upstream," "downstream," or "parallel" to that conducted in the other contracting state. Thus, for example, if the U.S. activity of a Canadian resident company 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. Income is considered **"incidental to"** a trade or business if, for example, it arises from the short-term investment of working capital of the resident in securities issued by persons in the state of source. ***U.S. Treasury Technical Explanation to the Fifth Protocol to the Treaty.***

An item of income is considered to be derived **in connection with** or is **incidental to** an **active trade or business** in the United States or Canada even though the resident claiming the benefits derives the income directly or indirectly through one or more other persons that are residents of Canada or the United States, respectively. 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 it and the operating subsidiary. ***U.S. Treasury Technical Explanation to the Fifth Protocol to the Treaty.***

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 television sets 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 television sets 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 sets for sale in several countries, generating a much larger amount of income. It might attempt to argue that the U.S.-source income is generated from business activities in the United States related to the television sales activity of the Canadian parent and that the dividend income should be subject to U.S. tax at the 5 percent rate provided by Article X (Dividends) of the treaty. However, the substantiality test would not be met in this example, so the dividends would remain subject to withholding in the United States at a rate of 30 percent. ***U.S. Treasury Technical Explanation to the Fifth Protocol to the Treaty.***

NOTE: Neither the treaty nor the U.S. Treasury Technical Explanation to the fifth protocol clarifies whether the substantiality requirement applies to unrelated parties and, if so, how a Canadian company can compare the relative size of its active trade or business in Canada to the unrelated payee's trade or business in the United States.

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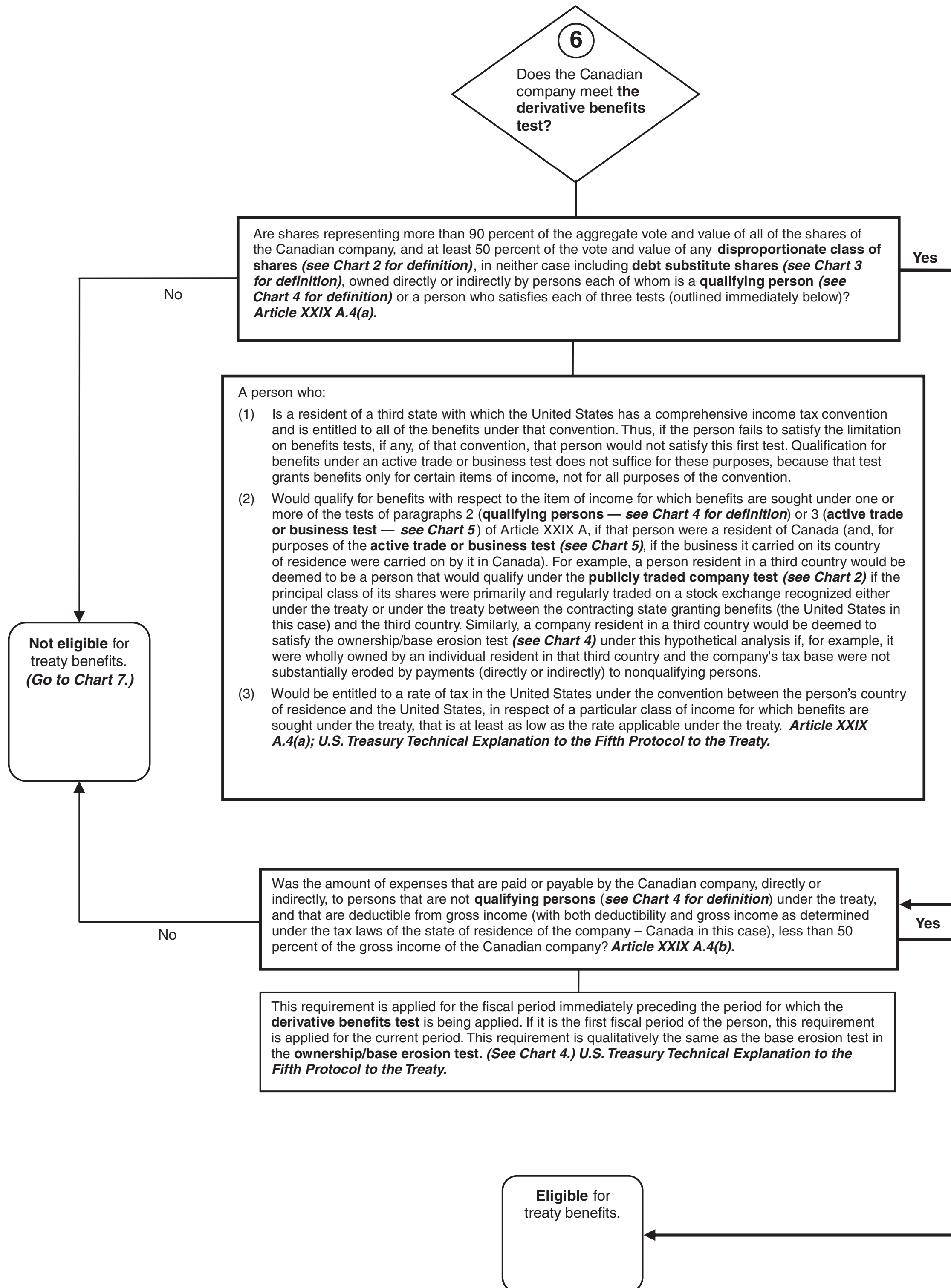
Chart 6. Derivative Benefits Test Under Article XXIX A.4 (LOB) of the Canada-U.S. Tax Treaty

(Only applies to treaty benefits sought under Articles X (Dividends), XI (Interest), and XII (Royalties))



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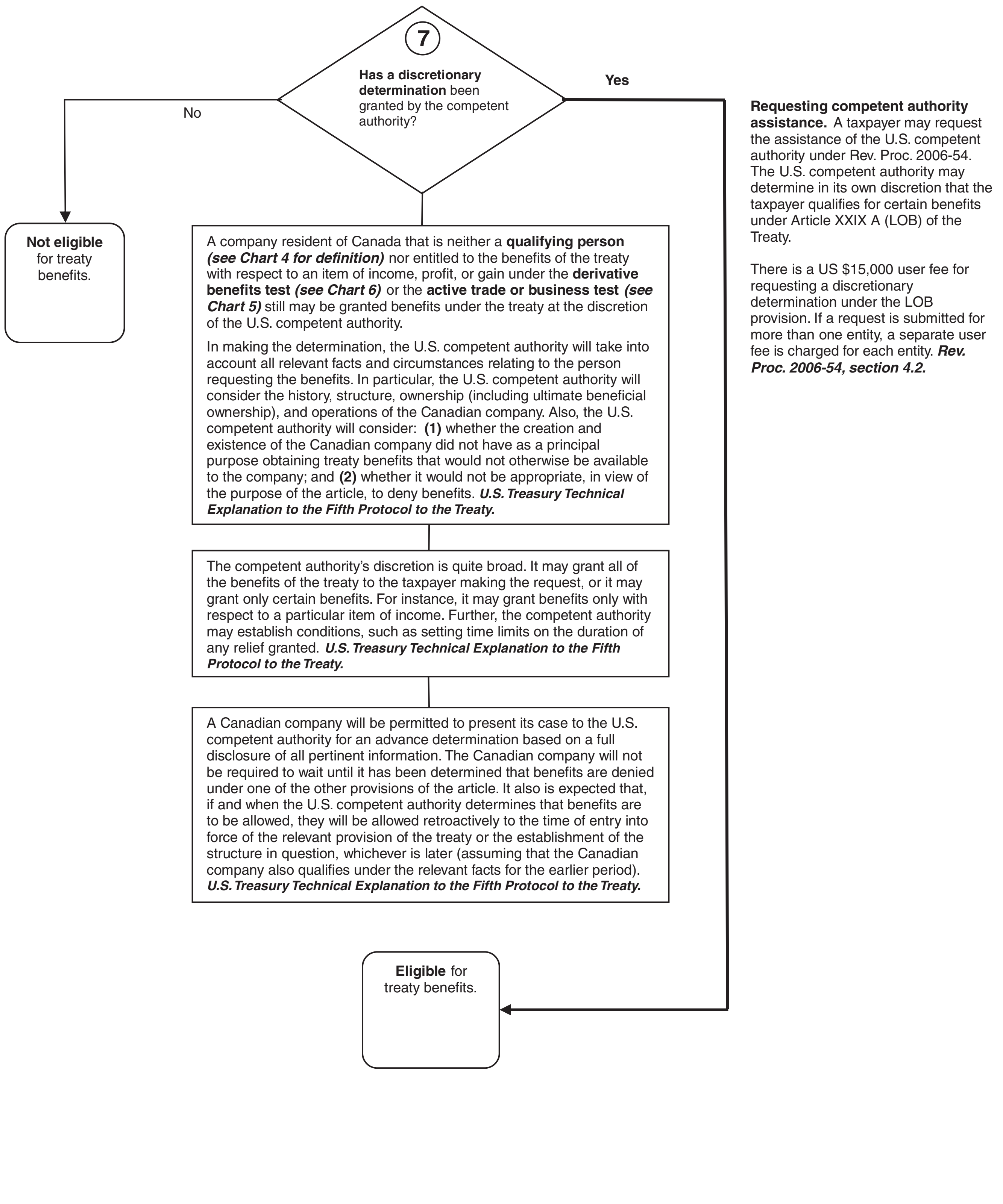

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