International Fiscal Association (IFA) Conference
Canada Revenue Agency Roundtable

May 17, 2012

Beneficial Ownership

Question

On two occasions, Canadian courts have considered the question of whether a recipient of an income payment was the beneficial owner of the income for treaty purposes. In both instances, the courts allowed the appeals of the taxpayers and held that the recipients in question were the beneficial owners of the respective payments, with the result that treaty benefits were found to apply to the income amounts at issue.

In the recent judgment of the Tax Court of Canada in *Velcro Canada Inc.* v. *The Queen*,[1] it was held that Canadian-source royalty income paid to a Netherlands resident was beneficially owned by that resident under the Canada-Netherlands Tax Convention, despite the fact that the recipient had a corresponding obligation to pay a royalty to another person, who was not entitled to benefits under that treaty, based, to a large extent, on the amount of the Canadian-source royalty received. The Tax Court of Canada followed the earlier decision of the Federal Court of Appeal in *Prévost Car Inc.* v. *The Queen*.[2] In *Prévost Car*, dividends paid to a Netherlands-resident corporation were found to be beneficially owned by the corporation, despite the fact that its shareholders, neither of whom was entitled to benefits under that treaty, had an agreement specifying that the corporation would pay dividends to the shareholders out of the Canadian-source dividend income received by the corporation.

In addition, it is noted that a discussion draft proposed changes to the commentary in Articles 10, 11 and 12 of the OECD Model Tax Convention concerning beneficial ownership was published on April 29, 2011.[3] As well, disputes concerning the interpretation of beneficial ownership continue to arise between tax authorities and taxpayers in a number of other countries.

Having regard to the *Prévost Car* and *Velcro Canada* decisions, is CRA continuing to challenge beneficial ownership? If so, would CRA comment on what factors it will take into account in determining beneficial ownership in light of these cases?

Response

Canada's income tax conventions generally limit Canada's right to tax Canadian-source dividend, royalty and interest payments, but only if the recipient of the payment is the beneficial

[1] 2007-1806(IT)G [hereinafter *Velcro Canada*].
[2] 2009 DTC 5053 (FCA); [2009] 3 CTC 160, 2008 DTC 3080 (TCC); [2008] 5 CTC 2306 [hereinafter *Prévost Car*].
[3] OECD Working Party 1 on Tax Conventions and Related Questions (OECD Committee on Fiscal Affairs) Clarification of the Meaning of "Beneficial Owner"interpretation of this term in treaties

owner of the income. Therefore, treaty benefits will only apply to such payments in a particular set of circumstances if the recipient is the beneficial owner of the income. Where a payment is received by a person or an entity in the capacity as an agent or nominee for another person, that recipient will not be considered the beneficial owner of that income for treaty purposes.

Where a recipient of income does not receive the payment as agent or nominee for another party, the CRA will consider the recipient to be the beneficial owner of the income if the payment is received for the recipient's own use and enjoyment and the recipient assumes risk and control over the payment. In light of *Prévost Car* and *Velcro Canada*, the CRA will generally accept that a payment will be for the recipient's use and enjoyment, and that the recipient assumes risk and control over the payment, if the recipient holds a sufficient degree of discretion with respect to the use or application of the payment.

Although a resident of a treaty country may be considered the beneficial owner of a payment of income, entitlement to treaty benefits is always subject to the application of the general anti-avoidance rule (the "GAAR"). Where a transaction or a series of transactions is carried out so that income is paid to a treaty resident in order to obtain the benefits of the particular treaty, and those benefits would not have applied in the absence of the transaction or the series of transactions, the CRA will give consideration to the application of the GAAR to disallow those treaty benefits.

Nothing in the foregoing comments should be construed as a departure from the attribution of beneficial ownership of income that persons resident in the United States are considered to derive under Article IV(6) of the Canada-United States Tax Convention. The approach described in the commentary to Article IV(7) of the United States Treasury Department's Technical Explanation to the Fifth Protocol under the heading "*Interaction of paragraphs 6 and 7 with the determination of 'beneficial ownership'*" will continue to be applied.

Jackson MacGillivray

Treaty-Reduced Tax Withholdings

Background

With the introduction of forms NR301, 302 and 303, it seems that the CRA requires a higher degree of due diligence by a payer in determining whether the recipient is entitled to reduced tax withholdings. Previously the payer only required the name and address of the recipient to apply a lower treaty rate. The CRA allowed taxpayers until December 22, 2011, to gather the necessary information to complete these forms. This date was extended to December 22, 2012 unless the following criteria existed:

- the payee is known to act, even occasionally, as an agent or nominee (other than a Swiss agent or nominee);
- the payee is reported as "in care of" another person, or "in trust," or the address is a post office box;
- the mailing address provided for payment of interest or dividends is different from the registered address of the "owner";
- the payee is a flow through entity such as a partnership or limited liability company (that is not taxed on its worldwide income under the laws of another country); or
- there is reason to believe that a reduced rate will not apply due to limitation of benefits provisions in the Canada - United States tax treaty.

Regardless of the transition, if in doubt, we understand that the forms should be completed. As a result, if the payer obtains the relevant information for this form, it seems that they should not be subject to any under withholding of tax or interest and penalties.

Questions

1. If it is not possible to make this general statement, would the CRA be willing to provide some guidance on when it would provide this due diligence relief?

2. It would be expected that payers will withhold if in doubt, and that there will be more refund requests by recipients. The mechanism for requesting a refund is form NR7-R. Does the CRA have any plans to simplify the process by which refunds may be claimed?

Response

1. The CRA recommends that payers or intermediaries collect the information requested on forms NR301, NR302, and NR303 since this information on beneficial ownership, residency, and eligibility for treaty benefits is generally the information the payer or intermediary will need to establish that a tax treaty rate applies. Since the payee is an active participant in the payer’s determination of the withholding tax rate and is providing a written certification, this should reduce instances of non-resident payees providing insufficient or misleading information to payers.

If the CRA determines that not enough Part XIII tax has been withheld on a payment to a non-resident, an assessment (including interest) can be issued to the payer, the non-resident recipient, or both. It can also be issued to an agent of the payer or the non-resident payee. If an assessment of tax is issued to the payer or an agent/intermediary, the amount assessed is also subject to a penalty.

You can ask for penalty and/or interest relief under subsection 220(3.1) by submitting a completed Form RC4288, *Request for Taxpayer Relief*. This form contains instructions on how to support your request and includes mailing addresses for the taxpayer relief intake centres. See Information Circular IC07-1, *Taxpayer Relief Provisions* for additional details including administrative guidelines that the CRA follows when making a discretionary decision.

The CRA will consider whether a taxpayer has exercised a reasonable amount of care when deciding if relief is warranted. The payer's level of effort to collect the forms or the information requested on them (a written declaration by the non-resident of beneficial ownership, residency, and eligibility for tax treaty benefits) in order to determine and apply the correct tax rate is important. Each relief request will be reviewed on a case-by-case basis taking into account the facts of the particular situation.

2. The CRA is committed to looking at the process through which Part XIII tax is refunded. The CRA has recently reviewed its internal processing of NR7-R applications and has implemented streamlined procedures that allow for faster processing of applications. The CRA continues to investigate further refinements to the process in order to make the refunding of Part XIII tax more efficient for taxpayers.

Transfer Pricing Cases

Question

Could you provide us with an update on paragraph 247(2)(b) assessments and the role of the Transfer Pricing Review Committee (TPRC) in reviewing the application of this provision? In addition, could you please provide us the most recent TPRC statistics with respect to both penalty application and re-characterization?

Response

Recharacterization Process

A. Context/Background

Proposed assessments to recharacterize a transaction under paragraph 247(2)(b) and (d) are referred to the Transfer Pricing Review Committee (TPRC) before the assessment is issued, to ensure fair and consistent application.

B. TPRC Membership

In general, the committee will include:

- The director of the International Tax Division (ITD) – the Chairperson of the TPRC
- The Chief Economist from ITD
- Managers of the International Advisory Services Sections (IASS) within ITD
- The manager from the Transfer Pricing Specialty Section in ITD
- A legal representative from the Department of Justice

For final consideration of cases involving the application of paragraphs 247(2)(b) and (d) of the *Income Tax Act* (ITA), a manager from the Aggressive Tax Planning Division and a senior official from the Tax Policy Branch of the Department of Finance will be asked to participate.

C. Three-Stage Approach

In situations involving the application of paragraphs 247(2)(b) and (d), the TPRC uses a three-stage approach: (1) initial consideration, (2) consideration of a formal referral, and (3) final consideration.

(1) Initial consideration (1st stage)

As soon as it becomes apparent that paragraphs 247(2)(b) and (d) may be recommended as an assessing position, an initial referral is made to the TPRC. The early referral will result in a more timely evaluation of whether the auditor should continue with an in-depth audit of the transaction. If the TPRC considers that recharacterization may be applicable, the auditor will carry out an in-depth examination to determine whether the facts support an application of the recharacterization provision.

(2) Consideration of a formal referral (2nd stage)

Once the audit is complete, but before a proposal letter is issued, the auditor must formally refer the case to the TPRC. The auditor must provide the taxpayer a copy of the fact portion

of the referral. This will allow the taxpayer to submit additional information in order to seek agreement on the facts of the case. The taxpayer's representations and the additional information will be taken into consideration when completing the formal referral to the TPRC.

The TPRC members will review the formal referral and discuss whether the facts and circumstances support the application of the recharacterization provision. In cases in which the TPRC decides that the auditor should proceed with recharacterization, the auditor will issue the proposal letter.

(3) Final consideration (3rd stage)
If additional representations are made by the taxpayer in response to the proposal letter, the auditor will forward the additional representations along with the auditor's comments for the TPRC's final consideration. The Assistant Director of Audit of the Tax Services Office will be informed of the final decision and reasons by memorandum.

The three stage process for referrals to the TPRC is a mandatory referral policy when the file is under audit however the issue of whether paragraph 247(2)(b) breaches procedural fairness if added at pleadings, despite not being presented to the TPRC, was considered in two recent cases before the Tax Court of Canada: Cameco and GE Capital Funding. The decision of the Court in both cases found that the administrative guidelines of the CRA are not binding and do not override the Act. Accordingly, the Minister of Justice is not precluded from adding paragraph 247(2)(b) at pleadings even if there has been no referral to the TPRC. It is our understanding that the decision in GE Capital Funding is now before the Federal Court of Appeal.

Statistics

Executive Summary as of April 24, 2012		
247(3) PENALTY REFERRALS		
Penalty Recommended	152	50.7%
Penalty not Recommended	148	49.3%
Total 247(3) Cases Referred	300	100.0%
247(2)(b) Re-characterizations		
Denied / abandoned	34	61.8%
Approved	11	20.0%
Ongoing	10	18.2%
Total Cases Referred	55	100.0%

Partnerships and Section 116 Clearance Certificates

Question

If a partnership, including a widely-held partnership or a partnership in a multi-tier partnership structure, proposes to dispose of Canadian real estate, a clearance certificate in respect of the disposition will not be available without providing a complete disclosure of all partners, including indirect partners of the partnership. However, in such situations, it may often not be possible to provide a full disclosure of the indirect partners. As a result, a clearance certificate in respect of the disposition may not be available, even in situations where full payment or sufficient security in respect of the tax resulting from the disposition has been provided to the Minister. Would the CRA consider providing further relief in such situations?

Response

The "non-resident person" in section 116 of the Act refers to each partner individually. Therefore, each partner is required to notify the CRA of a disposition of taxable Canadian property by the partnership. In this regard, it is current CRA policy to accept one notification of disposition filed on behalf of all partners on the condition that sufficient information about each individual partner is provided. Therefore, along with the one notice, the CRA requires a complete listing of the non-resident partners who are disposing of the property, including their Canadian and foreign addresses, tax identification numbers, percentage of ownership, and their respective portion of the payments or security. A partnership cannot file one income tax return on behalf of all the partners because the legislation does not provide for this filing method. Generally, each partner is required to file a tax return as each partner's final tax liability will be determined when the tax returns are filed and assessed.

Definition of Taxable Canadian Property

Considering August 27/10 proposed changes to the taxable Canadian property ("TCP") definition in subsection 248(1) of the Act and Roundtable response to Q13 from the 2011 Canadian Tax Foundation Conference could the CRA provide comments on the following:

1. In assessing the amount of immovable property that a Parent derives from shares of a Subsidiary what is the correct approach:
   a) full value approach;
   b) proportionate value approach; or
   c) consolidated gross asset approach?

In answering, consider the current wording and the proposed August 27, 2010 wording of the TCP definition.

2. How would a debt between a Parent and a wholly-owned Subsidiary impact the determination?

3. Are investments in partnerships treated differently than investments in shares of a Subsidiary for purposes of determining a Parent's investment in immovable property?

Response

1. The CRA is of the view that the determination of whether a share of a corporation derives its value principally from real or immovable property situated in Canada (and certain other property listed in subparagraphs (d)(ii), (iii) and (iv) of the definition of "TCP" in subsection 248(1) which for the purposes of the remainder of our response will be included when we refer to "real or immovable property situated in Canada") should be made by reference to the FMV of the properties of the company without taking into account its debts or other liabilities.

   Where a non-resident disposes of shares of a Parent corporation that has a Subsidiary the CRA uses the proportionate value approach in determining to what extent the shares of the Subsidiary represent real or immovable property of the Parent. A determination will need to be made of the fair market value (FMV) of the shares of the Subsidiary. Moreover, a determination will need to be made of the proportion of the total gross assets of the Subsidiary that comprises of real or immovable property situated in Canada. Under the current wording of the "TCP" definition, an amount equal to that same proportion of the FMV of the shares of the Subsidiary will be considered real or immovable property situated in Canada of the Parent in the determination of whether the shares of the Parent derive their value principally from real or immovable property situated in Canada.

   On August 27, 2010 the Department of Finance released draft legislation applicable after March 4, 2010, that would prevent indirect "look-through" to the property of the Subsidiary in the event that the shares of the Subsidiary would not themselves be TCP at the particular time.

If such legislation is enacted as proposed and the shares of the Subsidiary would not themselves be TCP, the full value of the shares of the Subsidiary owned by the Parent will be viewed as property other than real or immovable property situated in Canada in the determination of whether the shares of the Parent derive their value principally from real or immovable property situated in Canada.

2. Indebtedness between a Parent and a wholly-owned Subsidiary has no impact on the determination of whether the value of the shares of the Parent was derived directly or indirectly from real or immovable property situated in Canada. If the shares of the Parent would be TCP had the Parent capitalized its wholly-owned Subsidiary with only equity, then such shares will be considered TCP if the Parent capitalizes the Subsidiary in part with equity and in part with debt.

3. When testing whether a share of a corporation that has an interest in a partnership derives its value principally from real or immovable property situated in Canada, the CRA is of the view that the analysis should proceed on the same basis as where the corporation holds shares in another corporation.

Olli Laurikainen

Professional firms providing services in Canada

Question

If Regulation 105 withholding is deducted from payments for services made to a US partnership, does the CRA require every non-resident partner of US partnership that is allocated (under partnership agreement) income pertaining to the activities carried on by the partnership in Canada to file a Canadian tax return to claim a refund of their share of the withholding?

Response

Regulation 105 withholding does not represent a final tax of the non-resident. Rather, it is a payment on account of the non-resident's potential Part I tax liability to Canada. The ultimate tax liability is determined after the assessment of the non-resident's Canadian income tax return. Non-resident partners of a partnership are required to file a Canadian income tax return to calculate their tax liability and to obtain a refund. There is currently no administrative procedure whereby a refund can be issued in respect of a particular non-resident partner's share of the Regulation 105 withholding without that partner filing a tax return. However, where a partnership can demonstrate, based on treaty protection, that the normally required withholding is in excess of the ultimate tax liability, the partnership can make an application for a treaty-based waiver of Regulation 105 withholding on behalf of the partnership.

T1134 Forms

Questions

Status of revised 1134 a and b forms? Is there a plan to allow electronic filing of 1134 forms?

Response

Status of revised T1134A and B forms

Forms T1134A and B have been reviewed by external and internal stakeholders. These forms are in the final stages and have been forwarded to our publishing area.

In order to simplify the reporting process, these forms have been combined and restructured into:

- A summary return for the reporting entity, which captures tombstone and summary information only once, regardless of the number of foreign affiliates;
- Separate supplements for each foreign affiliate to capture the remaining information; and
- Revisions to information previously required on these forms include:
    - The filing thresholds remain unchanged however the meaning of the term "gross receipts" has been clarified to include all receipts (such as loans), not just income amounts.
    - Links to the official list of NAICS codes on the Statistics Canada website and to the T4061 guide on NR4 for the list of country codes. This eliminates the additional pages on the form.
    - An area was added to capture the elected functional currency, if any.
    - Actual amounts for the foreign affiliate's gross revenue are required instead of selecting a set revenue range.
    - Previously, an organizational chart was requested as an attachment however information on group structure is now required in a structured format similar to T2 Schedule 9. This will facilitate future electronic capture of information.
    - Modifications were made to reflect legislative changes to section 95 of the Income Tax Act.

Plans for electronic filing

The International Tax Division of the CRA participates in the International Tax Data Working Group, which reports to the Assistant Commissioner of the Strategies and Integration Branch of the CRA and the Assistant Deputy Minister of the Tax Policy Branch of the Department of Finance. The mandate of this working group is to examine and recommend ways to improve the reliability and utility of data obtained from international tax forms, taking into account the recommendations of the Subcommittee on International Tax Forms (established under the Advisory Panel on Canada's System of International

Taxation). E-filing of foreign reporting forms is an avenue currently being studied by the working group. Although the CRA recognized the importance of e-filing from an efficiency and quality perspective, the Agency is currently ensuring that all their forms are available in alternate formats to comply with the Federal Court decision in the Jodhan case. We are, however, continuing to study ways to allow these forms to be captured electronically in a cost effective and accessible format.

Policy Initiatives

Question

Can you give us an update on any policy initiatives being considered by the International Tax Division?

Response

The International Tax Division implemented a policy review committee in June 2011 in order to generate international tax policy. This committee is made up of the same members as the TPRC. As a result of the work of this committee, the International Tax Division will issue the following two memorandums shortly:

- TPM-13, *Referrals to the Transfer Pricing Review Committee*, which replaces TPM-07 and provides guidelines for referrals to the TPRC regarding possible transfer pricing assessments under paragraphs 247(2)(b) and (d), and penalties under subsection 247(3) of the *Income Tax Act*;

- TPM-14, *2010 Update of the OECD Transfer Pricing Guidelines*, which is to provide an overview of the significant changes made in the 2010 version of the OECD and of the CRA's position regarding these changes.

International Initiatives

Question

Can you give us an update on other international initiatives and co-operation such as JITSIC, OECD, Global Forum on Exchange of Information?

Response

Joint International Tax Shelter Information Center (JITSIC)

JITSIC continues to provide the International and Large Business Directorate (ILBD) opportunities to collaborate with international partners in addressing Aggressive Tax Planning. France and Germany are now both full members of JITSIC bringing the total membership to 9 countries – Canada, Australia, the U.S., the U.K., Japan, Korea, China, France and Germany. There are no plans to increase the membership at this time.

Our core work remains exchanging information on abusive tax schemes and those who promote them. Taxpayer specific exchanges are our priority and are conducted within bilateral treaties.

We have exchanged critical information on a significant number of cases. Noteworthy examples include offshore credit cards, tax shelters, foreign tax credit generators, structured financing, hybrid instruments and other financial products.

We anticipate reaching our 1000th exchange in the first quarter of this fiscal period.
JITSIC has also played a role in addressing offshore and tax haven non-compliant activities.

JITSIC will continue to play an important role in tackling cross-border abusive tax transactions. The work of JITSIC fits naturally within the current international agenda of increased use of information exchange, sharing of intelligence between tax authorities and the focus on cross-border tax avoidance.

OECD

The Canada Revenue Agency (CRA) continues to be an active participant in all areas of the OECD's work on tax, which is carried out by the Committee on Fiscal Affairs (CFA) and the Forum on Tax Administration (FTA).

At the CFA, Canada is jointly represented on many sub-bodies by both CRA and Finance Canada; the CRA participates in Working Parties 1 (Tax Treaties), 6 (Taxation of Multinationals), 9 (Consumption Taxes), and 10 (Exchange of Information and Tax Compliance).

Canada is currently the Chair of Working Party 6, which is responsible for maintaining and updating the OECD Model Tax Convention (MTC), so we will focus our update on that CFA sub-body.

- WP6 is currently working on two major projects; one involves the Transfer Pricing Aspect of Intangibles and the other focuses on transfer pricing simplification.

- The intangible project, since its commencement in July 2010, is progressing rapidly.
    - Three business consultations were held and at its March 2012 meeting, WP6 discussed the first proposed revised draft of Chapter VI, as a single document.

    - In addition to the revised draft of Chapter VI, the document includes a proposed revision of the Annex to Chapter VI.

    - The Annex contains examples to illustrate the application of the provisions of the specific parts of the Chapter.

    - WP6 approved, at its May 2012 meeting, the release of an interim version of the revised Chapter VI, as a Discussion Draft for public comments, to be provided by September 14, 2012.

    - It is anticipated that a public consultation on the Discussion Draft will be held in November 2012.

- To address concerns from Non-OECD Economies regarding the complexity of OECD transfer pricing guidelines, the project on the Administrative Aspects of Transfer Pricing started with a survey of the transfer pricing simplification measures adopted in several participating countries.

    - Released in June 2011, the Multi-Country Analysis of Existing Transfer Pricing Simplification Measures, analyzed five categories of simplification measures.

    - These measures, combined with the public comments received on the administrative aspects of transfer pricing, helped identify the following work streams:
        - Revision of the language of Chapter IV with respect to safe harbour.
        - Creation of model memoranda of understanding (MOUs) for use by country competent authorities in adopting bilateral safe harbours.
        - Work on streamlining transfer pricing documentation.
        - Work related to the allocation of low value added services.
        - Development of draft MOUs, and potentially other tools, related to the processing of low-due diligence Advanced Pricing Arrangements.

- Currently, WP6 is finalizing the revision of the existing guidance on safe harbours, in Chapter IV, to reflect the experience acquired by countries since 1995.

  - WP6 has approved the release of a Discussion Draft on the revision of the revised Transfer Pricing Guidelines language on safe harbours and related draft MOUs, for public comments, to be provided by September 14, 2012.

  - A preliminary draft on the work streams related to transfer pricing documentation and the allocation of low value added services will be prepared during the summer of 2012 for initial discussion at the November 2012 WP6 meeting.

  - Revisions will be expected following the November meeting, with additional discussions in March 2013 and the publication of a Discussion Draft for public comment thereafter. More details on these work streamlines will be released in the future.

- The OECD's first Global Forum on Transfer Pricing, which took place on March 26 and 27, 2012, was attended by about 300 tax officials from 90 countries, economies and international organizations.

  - The need to simplify transfer pricing rules, to strengthen the guidelines on intangibles and to improve the efficiency of dispute resolution was discussed.

  - The Global Forum panels were a great opportunity to hold thorough discussions with a large number of country representatives on important transfer pricing matters.

  - Delegates appreciated the discussions to improve the administration of transfer pricing and to provide support for the efficient implementation and development of transfer pricing regimes in non-OECD economies.

Global Forum on Transparency and Exchange of Information

- The Global Forum on Transparency and Exchange of Information, which now has 108 members, is the multilateral framework which continues to work to improve the international flow of information for tax purposes.

- It conducts peer reviews of its member jurisdictions' ability to co-operate with other tax administrations in accordance with the internationally agreed standard.

- Canada has made significant progress in negotiating Tax Information Exchange Agreements (TIEAs) since signing its first agreement in 2009. Currently there are 14 TIEAs in force, 2 more are signed and another 14 are under negotiation. These are in addition to Canada's 89 comprehensive tax treaties which also include exchange of information.

Forum on Tax Administration

- The FTA is a Commissioner-level body whose membership is comprised of representatives from 43 countries, including all of the G20 and selected non-OECD economies.

- Canada is represented by the Commissioner of the Canada Revenue Agency, and subject matter experts from across the Agency are involved in its work of the FTA, either as delegates to sub-bodies or participants on task groups.

- The work of the FTA is steered by a Bureau, which is a subset of 12 Commissioners, including our own, and all projects are sponsored by a Commissioner.

- Unlike the CFA, which is policy focused, the FTA concerns itself solely with tax administration issues.

- The work of the FTA is carried out in three ways:

    1. Networks – recently created bodies that meet virtually to address key and emerging trends in real time

    2. Sub-groups – made up of subject matter experts from the compliance and service areas – they meet once a year and carry out work as directed by the FTA Bureau

    3. Priority Projects – These projects are typically more horizontal in nature and are carried out by a task team.

- The CRA is actively engaged in all aspects of FTA work and our Commissioner is the sponsor of the Large Business Network.

Branch Tax Rate

Question

Assume that two corporations not resident in Canada are the partners of a partnership formed under United States laws. One partner is a resident of the United States under the Canada-United States Tax Convention (the "US Treaty"); the other partner is resident in a country with which Canada does not have a tax treaty. The partnership carries on identical business activities in both the United States and Canada through permanent establishments in both countries. The partnership has elected to be classified as a corporation for United States tax purposes.

Would the CRA be willing to clarify that Article X(6) of the US Treaty applies to business profits of partnerships that have "checked-the-box" to be classified as a corporation for United States tax purposes?

Response

It is our understanding that a partnership formed under United States laws is a "domestic corporation" under the *Internal Revenue Code* if the partnership elects to be a corporation. The partnership is then subject to United States corporate income tax liability on the same basis as any other corporation formed under United States laws. As a result, the partnership will be considered a "company" under Article III(1)(f) of the US Treaty and will also be considered a resident of the United States under Article IV(1) of the US Treaty.

From a Canadian tax perspective, a partnership that is a resident of the United States under the US Treaty remains a partnership for the purposes of the Act. If the partnership carries on business in Canada through a permanent establishment, each non-resident member of the partnership must include their share of the profit earned through the permanent establishment in the computation of the member's "taxable income earned in Canada" under Part I of the Act. Where the non-resident member is a corporation, branch tax may also be payable by the member under Part XIV of the Act in respect of those profits. The rate of branch tax imposed under subsection 219(1) is 25%. Under Article X(6) of the US Treaty, the amount of branch tax that Canada is allowed to impose on the "earnings of a company" attributable to permanent establishments in Canada is limited to 5 percent of such earnings, to the extent the branch tax was not previously imposed on those earnings.

While branch tax liability is imposed on the members of the partnership and not on the partnership itself, a member of the partnership, who is required to include a share of the profits of the partnership in computing the member's branch tax liability, can access benefits under Article X(6) of the US Treaty ("partnership-level benefits") to the extent that the partnership could have claimed such benefits had the partnership been the entity subject to Canadian branch tax.

Although a partnership that has elected to be a domestic corporation for United States tax purposes is considered a resident of the United States under the US Treaty (a "US-resident

partnership"), the partnership would not be a "qualifying person" as defined in Article XXIX A(2) of the US Treaty. As a general matter, a company will only be a qualifying person if the company's share capital meets certain requirements. Due to the absence of share capital, it is not possible for the partnership to satisfy these conditions. For the same reason, treaty benefits are not allowed to the partnership under the "derivative benefits" test in Article XXIX A(4) of the US Treaty.

Consequently, "partnership-level benefits" under Article X(6) may only apply to business profits earned by a US-resident partnership through a Canadian permanent establishment in accordance with the "active trade or business" test under Article XXIX A(3), or, if treaty benefits are granted by the Canadian competent authority, under Article XXIX A(6). To satisfy the "active trade or business" test:

(a) the US-resident partnership must be engaged in the active conduct of a trade or business in the United States (other than the business of making or managing investments, unless those activities are carried on with customers in the ordinary course of business by a bank, an insurance company, a registered securities dealer or a deposit-taking financial institution);

(b) the US-resident partnership's earnings from carrying on a business through the Canadian permanent establishment must be connected with or incidental to the trade or business activity referred to in (a); and

(c) the trade or business activity referred to in (a) must be substantial in relation to activity carried on by the US-resident partnership through the Canadian permanent establishment.

Additionally, a member of the partnership that is itself eligible to claim treaty benefits under Article X(6) may still apply the reduced branch tax rate to its share of the partnership's profits earned through a Canadian permanent establishment.

In this regard, certain considerations result from the manner in which benefits under Article X(6) are calculated. For example, where "partnership-level benefits" are calculated based on the US-resident partnership's earnings pursuant to Article X(6), it is the CRA's view that no reduction would be made under Article X(6)(b) for any Canadian income tax liability of the members in respect of the earnings from the Canadian permanent establishment, nor would those earnings be computed to take into account expenses directly incurred by the members of the partnership. Consequently, where Article X(6) benefits are claimed based on the US-resident partnership's entitlement to treaty benefits, the member of the partnership may find that its share of the partnership's Article X(6) earnings amount exceeds the amount upon which Part XIV tax is otherwise payable under subsection 219(1).

Further issues may also arise with respect to the $500,000 earnings exemption available under Article X(6)(d). While the exemption may be deducted in the computation of the US-resident partnership's earnings, the deductible amount of the exemption must be reduced for previous exemption claims made by the partnership, and any other company not dealing at

arm's length with the partnership with respect to the same or a similar business.

In the event that a member of a US-resident partnership computes its Part XIV tax liability under Article X(6), and the resulting branch tax liability varies from the amount that would otherwise be payable by the member (e.g., if the member is resident in a non-treaty jurisdiction or another jurisdiction offering a treaty-reduced rate exceeding 5%), it would be advisable to submit an explanation to support the claim for Article X(6) treaty benefits along with the Schedule 20 accompanying the member's T2 Corporation Income Tax Return ("T2"). In circumstances where the T2 is filed electronically, the CRA may initially detect a discrepancy between the branch tax rate and the rate applicable to the country in which the member is resident. Before proceeding with the assessment of the tax return, it is anticipated that CRA personnel will contact the member to ascertain the reason for the discrepancy, and provide the member an opportunity to substantiate the claim for Article X(6) treaty benefits at that time.

Jackson MacGillivray

Competent Authority Agreements

Question

Some of Canada's tax treaties contain a provision in the Gains Article that allows the competent authority of a contracting state to enter into an agreement with a resident of the other contracting state to defer, on terms satisfactory to the competent authority, the recognition of the profit, gain or income realized in the course of a corporate organization, reorganization, amalgamation, division or similar transaction. Under the Canada-United States Tax Convention (the "U.S. Treaty"), the deferral provision (paragraph 8 of Article XIII) specifically states that the competent authority may agree, "in order to avoid double taxation", to defer the recognition of the profit, gain or income. In this respect, we note that, unlike the U.S. Treaty, the deferral provision in some of Canada's other tax treaties does not contain a specific reference to the purpose of the provision (i.e., the avoidance of double taxation). Is it the CRA's view that the purpose of the deferral provision under these other treaties may extend beyond providing relief from double taxation? If so, would the Canadian Competent Authority be willing to enter into a deferral agreement under one of these other treaties where the profit, gain or income is exempted or excluded from taxation under the domestic laws of the residence state?

Response

In our view, each of the deferral provisions in Canada's tax treaties is intended to achieve the same policy objective – to assist the competent authorities in addressing issues of potential juridical double taxation attributable to timing differences in the recognition of the profit, gain or income. Accordingly, in determining whether to exercise its discretion to provide a deferral agreement under any of Canada's tax treaties, the Canadian Competent Authority's primary concern is whether the agreement would further the policy objective of avoiding potential double taxation. In this respect, the Canadian Competent Authority requires taxpayers seeking a deferral agreement to demonstrate that the profit, gain or income for which an agreement is being sought is only deferred - not exempted or excluded - from taxation under the domestic laws of the residence state.

More specifically, the Canadian Competent Authority's position is that the guidance provided in paragraphs 76 to 85 of Information Circular 71-17R5, under the heading "Deferred Recognition of Profits, Gain or Income Pursuant to Paragraph 8 of Article XIII – Gains", is equally applicable to all requests made under the deferral provisions in any of Canada's tax treaties. The same conditions for eligibility will be applied and the Canadian Competent Authority will require the same information to be included in a request for a deferral whether the request is made pursuant to Article XIII(8) of the U.S. Treaty or a deferral provision in one of Canada's other tax treaties.

In addition, as explained at the 2007 IFA Conference, where a request for deferral is accepted by the Canadian Competent Authority, the agreement will be subject to a number of conditions, one of which provides for the immediate recognition of the deferred gain

upon the occurrence of certain triggering events during the deferral period. The same conditions will apply whether the agreement is made pursuant to the deferral provision of the U.S. Treaty or another treaty.