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Fifth Protocol Follies: How the Canadian Revenue Agency Cleverly Circumvented the U.S.-Canadian Tax Treaty to Preserve the Beloved NSULC

By Joseph B. Darby III, Esq. (Sullivan and Worcester LLP) and Sophia Nilsson, LL.M.

The United States and Canada have the longest and, quite famously, the most peaceful border in this not-very-peaceful world.

Canada—not China—is the single biggest trading partner of the United States, and the United States, of course, is Canada's biggest trading partner by a huge margin. An estimated $616 billion of trade crossed the U.S.-Canadian Border in 2012,[1] and even more will probably cross this year. It is therefore perplexing and difficult to explain why the U.S. and Canadian tax regimes interact as badly as they do. In particular, tax advisors to U.S. and Canadian businesses find that, when structuring a whole variety of ordinary business transactions, the U.S.-Canadian Border—3,000 miles long and still largely unguarded—is one of the easiest things in the world to trip over.[2]

An all-too-typical tax pothole was created by the 2008 amendments to the U.S.-Canadian Income Tax Treaty[3] (Treaty), known as the "Fifth Protocol."[4] The Fifth Protocol addressed numerous issues, and most of the changes were not controversial; however, one of the key provisions was a new limitation[5] on treaty benefits directed at so-called hybrid entities, which are business entities that are treated as fiscally-transparent entities (FTEs) in one tax jurisdiction but not in the other.[6] The new hybrid-entity provision was designed to curtail perceived tax abuses resulting from the use of hybrid transactions, which generally allowed a taxpayer to claim a current interest deduction in both Canada and the U.S. (a result called "double dipping"), while deferring recognition of the related interest income.[7]

However, in the process of putting a halt to double dipping, the Fifth Protocol inadvertently put the kibosh on an extremely popular Canadian business entity called the unlimited liability company (ULC). Shortly after the Fifth Protocol was approved, the Canadian Revenue Agency (CRA) belatedly realized that, by slamming the door on hybrid entities, it was also going to smash the fingers of almost every private U.S. corporate investor into Canada, virtually all of whom use the ULC as the business vehicle for inbound investments and business operations in Canada.

This was a door that Canada absolutely could not afford to close. A crisis was brewing north of the border. A savior was called for. But this time, instead of calling the Royal Canadian Mounted Police to come galloping to the rescue, the party the CRA decided to call on for rescue was … itself!

Taking the Fifth

The Fifth Protocol, which was the product of almost 10 years of negotiations between the U.S. and Canada, was initially signed in September 2007 and finally approved by the U.S. Senate in late 2008.[8] The key provision addressed in this article is new paragraph 7 to Article IV of the Treaty, which went into effect on January 1, 2010.[9]

Article IV(7)(b) soon came to play the role of "villain" in the new statutory scheme, but at least initially it was supposed to play the role of the good guy. This provision was aimed at abusive arrangements where hybrid-entity structures were employed to facilitate either "(1) duplicated interest deductions in the United States and Canada, or (2) a single, internally generated interest deduction in one country without offsetting interest income in the other country."[10] In short, the point was to lower the hammer on "double dipping."

Operating in Canada through a ULC provides several benefits to the U.S. individual owner.

The specific language used in Article IV(7)(b) was later the source of myriad unintended consequences, so it is worth quoting carefully. Article IV(7)(b) states that an amount of income, profit or gain shall be considered not to be paid to or derived by a person who is a resident of a "Contracting State" if "the person is considered under the taxation law of the other Contracting State to have received the amount from an entity that is a resident of that other State, but by reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is not the same as its treatment would be if that entity were not treated as fiscally transparent under the laws of that State."[11]

To illustrate, Article IV(7)(b) denies favorable Treaty benefits[12] on a U.S. investment structure into Canada if (1) a U.S. resident is viewed by Canada as having received a payment from a resident of Canada (a Corporation Resident in Canada (CRIC)); (2) the resident state (U.S.) regards the payor (CRIC) as an FTE; and (3) by reason of the payor being treated as an FTE by the resident state (U.S.), the treatment of the payment under U.S. tax law is not is not the same as it would be if the payor were not treated as an FTE.

This convoluted analytical structure, fortunately, can be distilled down to a much simpler analysis called the "Same Treatment Test." Under this test, one core issue is whether the payment in question gets the "same treatment" whether or not the payor is an FTE. According to the Technical Explanation to the Fifth Protocol (Technical Explanation),[13] the "same treatment" of a payment for U.S. purposes is determined under the principles established under IRC section 894 and the related regulations.[14] The vital elements of this test are the timing, quantum,[15] source and character of payments.[16] Although Canada does not have analogous guidelines, the CRA has agreed to apply comparable principles, except that the CRA has announced that the geographical source factor is not vital—it is only relevant to the extent it affects treatment under U.S. tax law.[17]

ULCs

A corporation with unlimited liability is a creature unknown to U.S. corporate law. The concept originated from the UK Companies Act of 1862,[18] and can still be found in certain common-law countries, i.e., countries such as Canada, with legal systems based on English law.[19] Nova Scotia was for many years the only province in Canada that recognized ULCs, and so the Nova Scotia ULC (NSULC) was (and continues to be) the most popular ULC vehicle. More recently, Alberta and British Columbia also adopted ULC statutes, in 2005 and 2007, respectively.[20] The differences between the provincial ULC statutes is beyond the scope of this article, but the British Columbian ULC generally follows the quaintly archaic structure of the NSULC, while the Albertan ULC (ABULC) is the "rebel" of the group, by allowing for some heretical modern nuances of corporate law.[21]

The ULC is treated as a corporation for Canadian income tax purposes, but under U.S. income tax regulations,[22] the ULC is the only Canadian business entity specifically identified as an "eligible entity" (i.e., eligible to check-the-box and be treated as a disregarded entity for U.S. income tax purposes). Thus, if the applicable election is made,[23] a ULC owned by a U.S. corporation will be disregarded and will be treated for U.S. purposes as a "branch" of the U.S. corporation conducting business operations directly in Canada.

Common U.S. Investment Structure into Canada

A U.S. taxpayer is subject to U.S. taxation on its worldwide income, and, in turn, is eligible for tax credits for foreign taxes paid on that income.[24] As a practical matter, there are two basic strategies that a U.S. taxpayer can use in international tax planning, which might be described as "Now" versus "Later," based on when the U.S. taxpayer intends to repatriate foreign earnings back to the U.S.

Under the "Later" strategy, the U.S. taxpayer expects to leave foreign earnings offshore more or less "permanently" for reinvestment in its foreign subsidiaries, and so the strategy is to try to locate taxable profits in a low-tax jurisdiction (or at least a lower tax jurisdiction than the U.S.). By contrast, under the "Now" strategy, the U.S. taxpayer anticipates that the foreign earnings will be repatriated to the U.S. in the near term, and so the strategy is for the income to be taxed in the U.S. immediately under some type of pass-through income structure, so that the U.S. taxpayer is paying tax immediately in the U.S. while simultaneously claiming an immediate direct tax credit for foreign taxes paid.[25] This latter approach—the Now strategy—is far more tax efficient than having the income taxed in a Canadian corporation,

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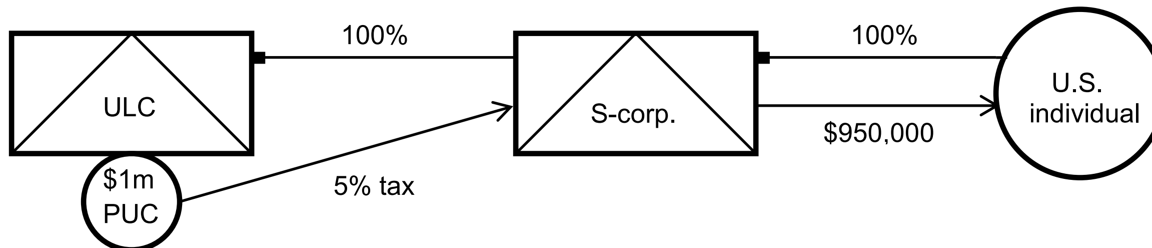
Diagram of Strategy #1



followed by a dividend distribution from Canada to the U.S. that is subject to Canadian withholding tax,[26] plus U.S. tax on the foreign dividend.[27]

One of the most common investment structures into Canada involves a U.S. individual conducting business through two FTEs: a U.S. S-corporation[28] that in turn is the sole equity owner of a Canadian ULC.[29] Operating in Canada through a ULC provides several benefits to the U.S. individual owner: (1) the losses of the Canadian ULC flow through the S-corporation to its U.S. shareholder(s), who can use the losses to offset U.S. income;[30] (2) the ULC is not subject to Canadian branch profits tax; (3) the ULC's Canadian taxes pass through the S-corporation to the U.S. shareholder(s) for U.S. tax purposes and are creditable on a current basis;[31] (4) there are no U.S. transfer pricing issues involved[32] and so one can focus on the Canadian transfer pricing regulation;[33] (5) neither the PFIC rules[34] nor the Subpart F[35] rules are applicable; and (6) a purchase and sale of a ULC's shares will be treated for U.S. tax purposes as a purchase and sale of the ULC's assets.[36]

Furthermore, the S-corporation shields the U.S. investor from the unlimited liability of the ULC (alternatively, an S-corporation can interpose a U.S. LLC to block liability one level down). Best of all, the S-corporation-ULC structure allows income earned in Canada to be taxed at the equivalent of a single level of U.S. tax, and also allows the U.S. shareholder(s) to claim currently a credit against U.S. taxes for the Canadian taxes paid.

The Fifth Protocol appeared to sabotage this popular U.S. tax structure by suddenly making the repatriation of funds from a ULC to its S-corporation parent subject to withholding tax at the general (25 percent) rate instead of the favorable (5 percent) Treaty rate.[37] For example, assume an NSULC earns income of $1,000,000 in Canada in a taxable year, and pays a combined Canadian corporate tax rate of 31 percent, or $310,000, to the CRA.[38] The NSULC then distributes the after-tax amount of $690,000 to its parent, the S-corporation, and pays the Treaty withholding tax of 5 percent, or $34,500. For U.S. purposes, the S-corporation will be deemed having paid these taxes,[39] and so the foreign tax credit (FTC) of $344,500 ($310,000 plus $34,500) will flow through to the individual owners of the S-corporation to be offset against U.S. tax liabilities on a current basis.[40] In this scenario, the Canadian combined effective tax rate is 34.45 percent, while the maximum U.S. individual income tax rate was 35 percent (before 2013) and is currently 39.6 percent (for 2013 and future years). This means that all the Canadian taxes paid should normally be eligible to be credited against the related U.S. income tax liabilities. However, if the 5 percent Treaty withholding rate is instead replaced by the general withholding rate of 25 percent (resulting in a total withholding tax of $172,500, and an increase in the withholding tax amount of $138,000), the effective Canadian tax rate totals 48.25 percent and would very likely create an excess-FTC for the U.S. individual that would not fully translate into a corresponding U.S. tax benefit.[41]

The Rescue Mission

Enter the CRA to the rescue. In 2009 and 2010, the CRA issued a series of announcements and rulings that provided guidance on how to avoid the problems created by the Same Treatment Test under the Fifth Protocol in many important situations.[42] Three separate tax-planning structures were essentially approved by the CRA, and these planning arrangements put the ULC back where it belongs, namely, under U.S. business entities as the vehicle through which U.S. taxpayers can continue to operate Canadian branch activities.[43]

Strategy #1: Playing Hockey with the PUC

Rather than paying a dividend to which Article IV(7)(b) of the Treaty would apply, the CRA rulings suggested a two-step arrangement whereby the Canadian ULC (1) increases its paid-up capital (PUC);[44] and (2) subsequently distributes the PUC amount to the S-corporation shareholders as nontaxable return of capital.[45] In the first step, the ULC would be deemed to have paid, and the U.S. shareholder to have received, a dividend equal to the amount of the increase in the PUC of the shares of the ULC according to Canadian law.[46] Because that "dividend" would be disregarded for U.S. purposes whether or not the ULC was treated as an FTE, there would be no change in the timing, quantum, source or character of the income, and therefore the "same treatment" test is satisfied.[47] Hence, the PUC amount is eligible for the beneficial treaty withholding tax rate of 5 percent. Because the second step of the transaction is treated as a return of capital rather than income to the ULC, the distribution would not be subject to Canadian withholding tax.[48]

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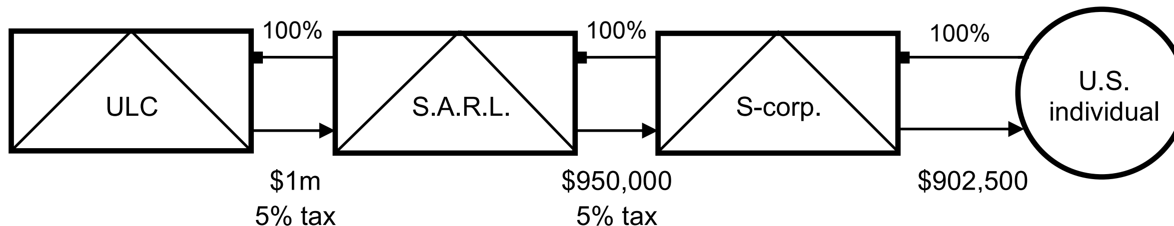
Diagram of Strategy #2



Strategy #2: Luxembourg Intermediary

A second planning device implicitly approved by the CRA would involve setting up a Luxembourg *société à responsabilité limitée* (S.A.R.L.) corporation as an intermediary between the U.S. S-corporation and the Canadian ULC.[49] The S.A.R.L. should elect to be treated as an FTE for U.S. tax purposes.[50] The S.A.R.L. would be considered a Luxembourg resident for Canadian tax purposes, and a dividend payment from the ULC to the S.A.R.L. would thus be eligible for the preferential tax rate of 5 percent under the Luxembourg-Canada treaty.[51] Furthermore, subsequent distributions to the U.S. S-corporation from the S.A.R.L. would be subject to withholding of an additional 5 percent, under the U.S.-Luxembourg tax treaty.[52] Both withholding taxes would be eligible for the foreign tax credit under U.S. law. This arrangement, however, is subject to the requirement under Canadian law that the S.A.R.L. be the "beneficial owner" (see discussion below) of the dividend it receives from the ULC.[53]

Setting up a S.A.R.L., which is a private limited liability company,[54] does incur costs that must be taken into account when considering the ULC's profitability and efficiency. The minimum capital required to set up a Luxembourg S.A.R.L. is currently €12,400, which can be contributed either in cash or in kind.[55] Therefore, this structure would probably not be appropriate unless the Canadian activities are expected to be quite substantial.

Beneficial Ownership Issues Arising under Strategy #2

To enjoy the favorable 5 percent withholding rate under the Canadian-Luxembourg Treaty, it is necessary for the Luxembourg entity to be treated as the "beneficial owner" of the NSULC. "Beneficial ownership" is a concept in Canadian treaties that is designed to curtail treaty shopping.[56] The Technical Explanation to Article IV(7)(b) indicates that it is the source state's interpretation of beneficial ownership that will govern.[57] In an S-corporation-NSULC structure, Canada is the "source state." This is important because Canadian rules on beneficial ownership are taxpayer-friendly thanks to some recent Canadian court decisions.[58]

The CRA has agreed to adhere to the rulings by the Canadian courts on beneficial ownership.[59] It was held in *Velcro Canada v. Her Majesty The Queen*,[60] which was decided only last year, that despite a Dutch intermediary's obligation to pay its parent a fixed percentage of royalties that it received from a Canadian subsidiary, it was not required (and was unable because of a comingled bank account) to deliver the exact same dollars that it received.[61] The court concluded that the Dutch intermediary had *some* (emphasis added) discretion as to the use of the royalties, referring to the "absolutely no discretion" test[62] applied in *Prévost Car Inc. v. The Queen*.[63] Arguably, based on *Velcro*, even a minimal level of discretion by an intermediary S.A.R.L. over certain features of a revenue stream may be sufficient to comply with the "beneficial ownership test."[64]

Strategy #3: Interest Repatriation The Grandparent Structure

The third structuring strategy approved by the CRA involved withholding tax on interest payments from a Canadian ULC to its U.S. corporate "grandparent."[65] To avoid adverse consquences under Article IV(7)(b), the loan transaction should be structured so that the loan is made to the ULC from its grandparent, rather than from the immediate parent corporation.[66] Thus, in the case of a ULC owned by a U.S. S-corporation, the loan would be from, and the interest payable to, the U.S. individual shareholder of the S-corporation rather than to the S-corporation itself.

To explain this structure further, capitalizing the ULC with debt obviously facilitates interest deductions against Canadian taxable income and is certainly attractive to U.S. investors,[67] especially if it can be coupled with a zero withholding tax on the interest payments.[68] Under the Fifth Protocol rules, the limitations imposed under Article IV(7)(b) would not apply to the interest payment so long as the tax treatment of the interest is the same in the hands of the payee as it would have been if the ULC were not an FTE.[69] However, under the Same Treatment Test, the treaty limitation will in fact apply if the loan is made between the ULC and the immediate S-corporation parent, and the reason is because interest paid by the ULC is not treated as income to the S-corporation under U.S. tax principles (i.e., because the ULC is an FTE and therefore the payment is disregarded and treated as if it were a payment by the S-corporation to itself). By contrast, if the ULC were not an FTE, the interest payment would be income to the S-corporation, and therefore the Same Treatment Test is not satisfied.

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The arrangement approved by the CRA addressing this problem involved a consolidated return group rather than an S-corporation group, but the general concepts should be the same. The CRA-approved transaction assumes that all shares of a ULC are owned by a U.S. subsidiary (USsub) of a U.S. corporation (USco) and that the corporate group files a consolidated return in the U.S. Assume that USco has made a loan to the ULC. In that consolidated tax return, interest included in the income of USco is offset by the flow-

The S-corporation-ULC structure allows income earned in Canada to be taxed at the equivalent of a single level of U.S. tax.

through interest expense deduction of USsub. If the ULC were not fiscally transparent for U.S. tax purposes, there would have been no offsetting interest expense deduction available to the consolidated group. Nevertheless, the CRA concluded that the "same treatment" test would be satisfied because only the item of income, being the interest, and not the corresponding expense item, is relevant.[70] The fact that the payor of the interest would be different for U.S. tax purposes (depending on whether the ULC is or is not a FTE) is not relevant.[71] Therefore, the onerous 25 percent withholding rate would not apply to this interest payment to the "grandparent" entity.

The CRA stated that the amount deducted by the ULC must be included in income by the grandparent,[72] and further clarified that this requirement is not that the amount received be treated identically, but rather that it has the same tax effect generally.[73]

However, because the purpose of Article IV(7)(b) was to curtail certain arrangements with interest, CRA raised a cautionary warning about the application of the Canadian general anti-avoidance rule (GAAR).[74] The GAAR is an over-arching anti-avoidance rule that CRA generally can rely on in any transaction to deny a tax benefit.

Observation: While the structure approved by the CRA involved a U.S. consolidated return group, the same strategy should work if an individual U.S. shareholder owning all the shares of an S-corporation makes the relevant loan directly to the ULC owned by the S-corporation and conducting business activities in Canada. (See Diagram of Strategy #3)

Strategy #3 Should also Apply to Royalties

The payment of royalties from a ULC to a "grandparent" entity also appears to benefit from a similar structure under Strategy #3,[75] and thus would allow such payments to benefit from the lower tax rate provided in Article XII of the Treaty.[76]

Conclusion

The Fifth Protocol added a variety of important and appropriate changes to the Treaty between the U.S. and Canada, but the biggest change was an unintended consequence that could have ended in disaster. Fortunately, once the CRA recognized that the Same Treatment Test was likely to discourage U.S. private investment into Canada (by killing the use of ULCs), the CRA did a very passable immitation of the Royal Canadian Mounted Police and went riding heroically to its own rescue. The CRA identified three "work around" strategies that should help many U.S. taxpayers avoid the onerous 25 percent Canadian withholding tax that would otherwise apply to payments made from a ULC to its U.S. parent corporation. Granted, when most people think of "heroism" they are not visualizing a Canadian tax bureaucracy issuing esoteric rulings on fiscally-transparent entities, but then heroism in this modern era sometimes arises in strange and unexpected ways.

In truth, the CRA deserves an appreciative salute from U.S. taxpayers for a job well done: O (as in low withholding tax) Canada, long may you live.

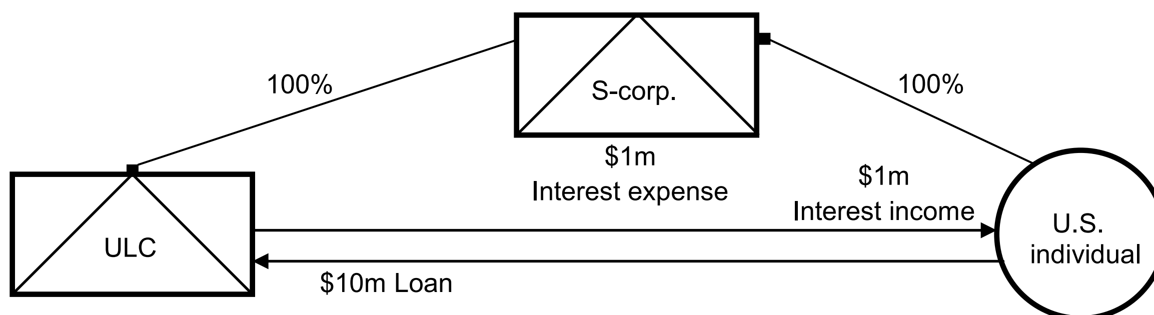
[1] United States Census Bureau. http://www.census.gov/foreign-trade/top/dst/2012/12/balance.html.

[2] *See* Darby, Joseph, "Virtual Mergers: Seeing is Believing." *Practical International Tax Strategies*, Vol. 10, No. 19 Dec. 2006, p. 2.

[3] Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital (1980).

[4] The Fifth Protocol to the 1980 U.S.-Canadian Income Tax Treaty was signed on September 21, 2007, but ratification by the parties took a significant amount of time. Canada ratified it on December 14, 2007, and the Fifth Protocol was finally ratified

Diagram of Strategy #3



by the United States on December 15, 2008, when the bill was signed by President Bush. Some of the provisions then took effect retroactively from January 1, 2008; however, the provisions relevant to this article, governing hybrid entities, took effect on January 1, 2010.

[5] Article IV(7)(b) of the U.S.-Canada Tax Treaty, available at http://www.fin.gc.ca/treaties-conventions/unitedstates-etatunis-eng.asp.

[6] Internal Revenue Code (IRC) section 894 with regulations; and IRS TD 8889.

[7] *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada*, *Prepared by the Joint Committee on Taxation for the Committee on Foreign Relations of the United States Senate*, *July 8, 2008*, p. 100, available on https://www.jct.gov/publications.html?func=startdown&id=1282.

[8] 110th Congress 2nd Session, Treaty Document 110-15: Protocol Amending 1980 Tax Convention with Canada.

[9] Article 27(3)(b) of the Fifth Protocol.

[10] *See* n.7 *supra.*

[11] *See* n.5, *supra.*

[12] The payments subject to withholding tax are thus not eligible for the favorable 5 percent withholding rate under the Treaty, but instead are subject to the general withholding rates, which for the U.S. is 30 percent and for Canada is 25 percent.

[13] *Department of the Treasury Technical Explanation of the Protocol Done at Chelsea on September 21, 2007 Amending the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital Done at Washington on September 26, 1980, as Amended by the Protocols Done on June 14, 1983, March 28, 1994, March 17, 1995, and July 29, 1997* http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/tecanada08.pdf.

[14] *Id.*, p. 4.

[15] Refers to amounts on a gross basis, without reference to losses, deductions or credits.

[16] CRA Doc No. 2009-0318491I7–Canada-United States Tax Treaty–Art. IV:6/IV:7 "same treatment."

[17] *Id.*

[18] Westaway, Patrick A., "The Life and Times of Canada's ULC," Dale and Lessmann LLP, January 24, 2012, http://www.dalelessmann.com/en/news/blog/life-and-times-canada's-ulc.

[19] *See e.g.*, Ireland (http://www.companyformations.ie/company-formations/company-types/#section3); Australia (http://www.companydirectors.com.au/Director-Resource-Centre/Organisation-Type/Organisation-definitions); and New Zealand (http://www.business.govt.nz/companies/learn-about/starting-a-company/unlimited-companies).

[20] Boidman, Nathan; Kandev, Michael, "Is the Nova Scotia Unlimited Liability Company Dead?," *Tax Notes International* Vol. 53 No.13, March 30 2009, available at http://www.dwpv.com/~/media/Files/PDF/Is_the_Nova_Scotia_Unlimited_Liability_Company_Dead.ashx.

[21] Bernstein, Jack, "Acquisition of Canadian Businesses by Nonresidents," *Tax Notes International*, October 24, 2011.

[22] Treas. Reg. section 301.7701-2(b)(8)(ii)(A)(1).

[23] The BCULC and ABULC may likewise check the box and be disregarded entities for U.S. income tax purposes.

[24] IRC Subtitle A, Chapter 1.

[25] IRC section 901(b)(1), Treas. Reg. section 1.901-2(f)(4)(ii).

[26] Canada Income Tax Act (ITA) section 212, reduced from 25 percent to 5 percent by Article X of the U.S.-Canadian Income Tax Treaty.

[27] IRC section 243(a) does not apply to distributions from foreign corporations and is therefore taxed in full as income on receipt by the U.S. corporate parent.

[28] An S-corporation is a corporation subject to the provisions of IRC Subchapter S, and is allowed flow-through treatment under IRC section 1366.

[29] The Canadian ULC is eligible to check-the-box under Treas. Reg. section 301.7701-2(b)(8)(ii)(A)(1).

[30] IRC section 1366.

[31] *See* n.25, *supra.*

[32] IRC section 482 requires "two or more organizations, trades or businesses."

[33] ITA section 247.

[34] Referring to the rules governing PFICs, IRC sections 1291-1298.

[35] Referring to the rules governing CFCs, IRC sections 951- 965.

[36] IRC section 338.

[37] *See* n.26, *supra.*

[38] Comprised of the "general rate" of 16 percent of corporate tax in Nova Scotia (effective as of June 14, 2013) plus the 15 percent Canadian federal tax rate (effective as of January 1, 2012). *See* http://www.cra-arc.gc.ca/tx/bsnss/tpcs/crprtns/prv/ns/menu-eng.html.

[39] IRC section 1366; Treas. Reg. section 1.901-2(f)(4)(ii).

[40] *Id.*

[41] This is a very detrimental result since excess tax credits can only be used against excess limitation, and may only be carried back one year and forward 10 years, as per IRC section 904(c). Bittker and Lokken, *Fundamentals of International Taxation* (2012/2013 edition) at 72.6.5.: "If a taxpayer's foreign income taxes for any year exceed the § 904(c) limitation for the year, the excess is carried back to the year preceding the taxable year, then to the year immediately following the taxable year, and then forward through the tenth year following the taxable year until the carryback or carryover is used." […] "A carried amount expires unused to the extent it cannot be used by the tenth succeeding year during which the excess foreign taxes were paid or incurred."

[42] *Inter alia,* CRA Doc. No. 2009-0343641R3; CRA Doc. No. 2009-0350471R3; and CRA Doc No. 2009-0318491I7.

[43] *Id.*

[44] Defined in ITA section 89(1).

[45] CRA Doc. No. 2009-0350471R3–Distribution of retained earnings by ULC.

[46] ITA section 84(1). The PUC is largely derived from the legal stated capital in the ULC and is normally created in connection with issuance of shares and reflects the amount paid for such issuance.

[47] In either case the dividend is recognized when the conversion transaction is executed.

[48] *See* n.21, *supra.*

[49] CRA Doc. No. 2009-0343641R3–Dividend paid by unlimited liability company to Dutch resident.

[50] Treas. Reg. sections 301.7701-2(a) and (b); and 301.7701-3(a).

[51] The Income Tax Treaty between Canada and Luxembourg is available at http://www.collectionscanada.gc.ca/webarchives/20071126040811/http://www.fin.gc.ca/news99/data/99-075_1e.html.

[52] The Income Tax Treaty between the U.S. and Luxemburg is available at http://www.gpo.gov/fdsys/pkg/CDOC-104tdoc33/pdf/CDOC-104tdoc33.pdf.

[53] *See* n.49, *supra.*

[54] The monetary liabilities of the shareholders are limited to

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their contribution and the shares are transferable only to a limited extent, etc., *see* "Business Portal" of the Government of Luxembourg, http://www.guichet.public.lu/entreprises/en/creation-developpement/forme-juridique/entreprise-individuelle_societe-personnes/sarl/index.html.

[55] *Id.*

[56] International Fiscal Association (IFA) Conference Canada Revenue Agency Roundtable, May 17, 2012, Document Number 2012-0444041C6, available at http://www.thor.ca/blog/wp-content/uploads/2013/01/2012-0444041C6.pdf.

[57] *See* n.13, *supra*, page 9.

[58] *Prévost Car Inc. v. The Queen*, 2009 D.T.C. 5053 (F.C.A.); and *Velcro Canada v. Her Majesty The Queen,* 2012 TCC 57.

[59] This is true provided "the recipient holds a sufficient degree of discretion with respect to the use or application of the payment." *See* n.56, *supra*.

[60] *Velcro Canada v. Her Majesty The Queen,* 2012 TCC 57.

[61] *Id. See also* Matthew Peters, "'Beneficial Owner'–CRA's Assessment of Velcro Doesn't Stick," Fraser Milner Casgrain, LLP, available at http://www.dentons.com/~/media/FMC%20Import/publications/pdf/0/0212%20Peters%20Matthew%20Beneficial%20Owner%20CRA.ashx.

[62] This test is only failed if the recipient has "absolutely no discretion" over the funds, and will thus in such case not be the beneficial owner. *See Prévost Car Inc. v. The Queen*, 2009 D.T.C. 5053 (F.C.A.), para. [13].

[63] *Prévost Car Inc. v. The Queen*, 2009 D.T.C. 5053 (F.C.A.).

[64] *See* n.61, *supra*.

[65] CRA Doc No. 2009-0318491I7, Example 9.

[66] *Id.*

[67] Interest payments are eligible for this treatment to the extent of Canada's thin capitalization rules in ITA section 18(4). Canada lowered its thin capitalization ratio from 2:1 to 1.5:1 for tax years beginning on January 1, 2013 and thereafter. If the debt capitalization exceeds this ratio, the interest will not only be denied deduction against income, but it will also be considered to be a deemed dividend.

[68] Article XI of the U.S.-Canada Tax Treaty. The zero percent withholding rate on interest payments took effect January 1, 2010. http://www.fin.gc.ca/treaties-conventions/unitedstates-etatunis-eng.asp.

[69] *See* n.13, *supra*.

[70] *See* n.16, *supra.*

[71] *Id.*

[72] The limitation by the Article IV(7)(b) intended to address such transactions where there is no income inclusion. *See* n.13, *supra.*

[73] CRA Clarifies Views on Planning for Canada-US Tax Treaty Changes, MNP, LLP Tax Alert, August 24, 2010, available at http://www.mnptax.ca/news/tax-alerts/2010/8/24/cra-clarifies-views-on-planning-for-canada-us-tax-treaty-changes.

[74] GAAR is codified in ITA section 245(2): "Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction." CRA interprets GAAR in CRA document IC88-2, where it is explained that an avoidance transaction does not include a transaction that "may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit." "Tax benefit" is defined to mean a reduction, avoidance or deferral of tax or other amount payable or an increase in a refund of tax or other amount under the Act. http://www.cra-arc.gc.ca/E/pub/tp/ic88-2/.

[75] CRA Doc No. 2009-0318491I7, Example 12.

[76] Article XII of the U.S.-Canada Tax Treaty allows for 10 percent withholding tax on royalties, although royalty payments for certain types of IP are exempted from tax all together.

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