Attorney Comments on Canada-U.S. Protocol, OECD Services Draft

Tax attorney Martin B. Tittle of Ann Arbor, Michigan, comments on the recent Canada-U.S. treaty protocol and the OECD's discussion draft on the treatment of services.

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Comments on U.S.-Canada Fifth Protocol and OECD Services Draft
by
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I. Fifth Protocol to U.S.-Canada Tax Treaty

Comments regarding the recently signed Fifth Protocol to the U.S.-Canada tax treaty have been released by the New York State Bar Association (NYSBA), Ernst & Young (E&Y), BDO Seidman, and the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants (CanJCT).

The CanJCT's analysis covers the widest spectrum -- Arts. IV (Residence), X (Dividends), XV (Income from Employment), and XXIX A (Limitation on Benefits), as well as Canadian compliance matters -- and therefore it will be used as a template for presentation of the concerns and recommendations of all four organizations.

Article IV (*Residence*)

The CanJCT makes several recommendations regarding new paragraph 6, which it calls the "FTE [Fiscally Transparent Entity] Relieving Rule," and new paragraph 7, the "FTE Corollary Rule." They are as follows:

- that the meaning of "fiscally transparent" be addressed in the technical explanation with examples and with particular reference to U.S. Subchapter S corporations;
- that the residence of partnerships be clarified if partnerships are FTEs;
- that the meaning and consequences of the term "derived" be explored, particularly with respect to whether it generates a "look-through" rule for source;
- that the factors that inform the meaning of the term "treatment," in the phrase "not the same . . . treatment," be explained with examples (suggested factors include character of income, the time income is recognized, and the payor);

- that the consequences of applying the FTE Relieving Rule be fully set forth, particularly with respect to situations involving a) one or more tiers of FTEs and b) ownership structures that cross the border more than once (e.g., Canadian-source income paid to a resident of Canada by reason of the resident's interest in a U.S. partnership or LLC); and
- that Canada and the U.S. agree not to apply the FTE Corollary Rule "where the amount in question is not deductible under the tax law of the source country."

The NYSBA's 29 January letter to Assistant Treasury Secretary for Tax Policy Eric Solomon and Acting IRS Commissioner Linda Stiff limits itself to application of the FTE Corollary Rule, which it says could cause an unfair denial of treaty benefits in at least seven different nonabusive scenarios. It then suggests, as one alternative, that "treatment [ ] be considered 'the same' if the timing, character and source" of items passing through a hybrid entity are not altered, "as a result of passing through the hybrid," in such a way as to "result in (i) a double deduction or a deduction without associated income inclusion, or (ii) double non-taxation of an income item."

BDO Seidman's William F. Roth, III addresses a narrower application of the FTE Corollary Rule in which a U.S. parent with a Canadian Unlimited Liability Company (ULC) subsidiary would, under the plain language of Art. IV(7)(b), see the nominal tax rate on its ULC dividends explode from 5 percent to 25 percent. He also points out that restructuring to avoid this result, by switching from a ULC to a CFC or branch, might run afoul of the Canadian General Anti-Avoidance Rule (GAAR).

Article X (*Dividends*)

New subparagraph 2(a) in Article X (Dividends) expands the "10 percent owner/5 percent preferential rate on cross-border dividends" provision to allow inclusion, in calculating the 10 percent, of a proportional amount of stock owned by a non-source-country FTE in which the dividend recipient has an ownership interest. The CanJCT suggests that "the method of determining the proportion of a company's ownership interest in one or more tiers of FTEs be clarified."

Article XV (*Income from Employment*)

The CanJCT notes problems in two areas. First, deletion of the words "in a calendar year" from the front language of paragraph 2 removes the time period that applied to the US$ 10,000 exemption in subparagraph 2(a) and thus makes operation of the exemption unclear.

Second, the phrases "paid by or on behalf of" and "borne by" in the new version of subparagraph 2(b) are ambiguous. For instance, how should this provision apply when a non-resident, no-PE parent "provides ongoing management services to a subsidiary in the source country on a cost reimbursement basis, and officers or employees of the parent travel to the source country from time to time in connection with such services?" Further, "[i]f remuneration can be 'paid by or on behalf of' or 'borne by' an entity other than the employer, what kind of tracing is necessary?" Finally, does removal of the phrase "which the employer has" make the term "permanent establishment" applicable to a PE of a resident of the source state?

Article XXIX A (*Limitation on Benefits*)

The CanJCT makes the following recommendations regarding this article:

- that FTEs of either country be disregarded for purposes of the definitions of "qualifying person" in subparagraphs 2(d) and (e);
- that the meanings of "principal class" and "primarily and regularly traded" in subparagraph 2(c) be clarified;
- that the phrase "directly or indirectly, to persons who are not qualifying persons" in the subparagraph 2(e) and 4(b) base erosion tests be clarified because in many cases, including, for example, the case of interest on widely held debt, it will not be possible to identify the "qualifying person" status of payees; and
- that the meaning of "in connection with or incidental to" and "business of making or managing investments" in paragraph 3 be clarified because those phrases have different meanings in Canadian and U.S. tax law.

E&Y's 22 January letter to Eric Solomon and Bob Hamilton, Senior Assistant Deputy Minister for Tax Policy in Canada's Department of Finance, addresses the "potential denial of treaty benefits by Canada that may result under" the new version of Art. XXIX A. The concern expressed, based on informal conversations with Canada Finance, is that Canada might not grant

> "Benefits under the Convention to a U.S. domestic corporation which has, in its ownership chain, U.S. limited liability companies that are treated as fiscally transparent for U.S. tax purposes (either as disregarded entities or partnerships). The basis for this concern is that Canada may not "look through" the LLCs to the ultimate owner(s) [who, in the hypothetical, would be one or more qualifying persons] in applying Paragraph 2(d) or (e) of Article XXIX A of the Convention for the purpose of determining whether or not the corporation is a "qualifying person," eligible for benefits under the Convention."

II. Comments on the OECD Services Draft

The OECD recently released "Public comments on the discussion draft on the tax treaty treatment of services, 17 January 2008."[1] The underlying public discussion draft was published by the OECD Committee on Fiscal Affairs in December 2006 (Doc 2006-25180 [PDF]; 2006 WTD 243-11.)

The "services permanent establishment (PE)" proposed in the discussion draft was implemented in an expanded form in the Fifth Protocol to the 1980 U.S.-Canada treaty.[2] Since the signing of that protocol in September 2007, Michael Mundaca, Deputy Assistant Treasury Secretary for International Tax Affairs, and Benedetta Kissel, Treasury Deputy International Tax Counsel, have made clear that inclusion in the protocol was a quid pro quo that does not change the U.S.'s fundamental opposition to this broadening of the concept of PE (Doc 2008-1203 [PDF], 2008 WTD 14-4 (Mundaca); Doc 2007-27371 [PDF], 2007 WTD 241-2 (Kissel)).

Comments on the discussion draft were received from eleven respondents:

- the OECD Business and Industry Advisory Committee (BIAC);
- Baker & McKenzie partner Carol Dunahoo on behalf of a group of U.S., UK, and Canadian companies;

- B&M partner Gary Sprague on behalf of the Software Coalition;
- the Federation Bancaire Francaise (FBF), an association of French banks;
- Woo Taik Kim, president of International Fiscal Association (IFA) Korea *Sadan Bobin*;
- the Tax Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW);
- Mohammad Tavakkol, Editor of the Maliyat Journal, an Iranian tax review;
- Felix Loose, Finance Manager, Corporate Taxation EMEA, BearingPoint Management & Technology Consultants, Frankfurt am Main; and member of the German industry working committee on transfer pricing (speaking on his own behalf);
- Hans Pilj, who lists his associations as "Deloitte Amsterdam, Tax Court of Appeals in The Hague, University of Leiden, and ITC Leiden";
- Radhakishan Rawal, a fairly well-known Indian treaty commentator; and
- David Ward of Davies Ward Phillips & Vineberg, well-known Canadian treaty expert.

Here are the six themes or ideas in their comments that caught my eye:

The first is outright opposition. The purpose of the OCED, say opponents, is to build and express consensus, and this expansion via an alternate provision undermines that purpose and risks the misconception that the alternate provision is endorsed by the OCED.

I agree that services PEs run the risk of breaking down the fairly strong consensus about what constitutes and should constitute a PE. However, that isn't a very forceful argument for excluding them from the Commentary. After all, the OCED model also does not contain a limitation on benefits (LOB) article, and yet the Commentary on Art. 1 provides sample language for one. Providing sample, alternate language allows for discussion and at least gives some structure and suggested limitation for those countries that choose to include a services PE in their agreements. My bottom line is that I like the idea of sample language, but I don't like the idea of "fuzzing up" the now very tightly defined, well-understood concept of PE.

The second theme is that the terms "services" and "connected project" need to be defined. Throwing their definitions into the domestic law of each country via Art. 3(2) introduces the very real possibility of double taxation. Regarding "connected project," factors suggested for use in creating a definition include the existence of a master service agreement, assignment of identical personnel, "application of the same software to various affiliates or activities," and the "commercial coherence" concept in OECD Commentary paras. 5.3 and 5.4.

Third is the suggestion that the new services PE needs to be coordinated with (i.e., equal with but separated from) the PEs created by Art. 5(3) building sites and construction and installation projects, so as not to overlap them.

The fourth theme is a concern that the new provision creates the potential for unfair discrimination between firms. One respondent outlines a potential problem with Art. 24 (Non-Discrimination) and the EC Treaty as interpreted by the European Court of Justice. Another frames the issue in terms of different sized firms, saying that a one-person enterprise would reach the 50-percent-of-gross-revenues threshold more quickly than a multi-person firm.

The fifth suggestion is to better define the individuals who can create a services PE. For instance, employees could be broadly defined as anyone "who can be economically considered an employee of the service provider . . ., irrespective of their legal relationship for work or civil law purposes."

Finally, more than one writer said the model language needs to provide more line-drawing guidance regarding the calculation of profits from a services PE. The concern is that cross-border provision of services frequently involves inputs and costs from the residence State, and that a lack of guidance could lead, not to taxation of profits, but effectively to taxation of gross receipts. A special concern is that "developing countries with poorly resourced tax administrations . . . may lack the capacity to appropriately attribute the profit using OECD principles." Further, in computing business profits, they may apply a "force of attraction" rule that would "tax related services not actually performed in their jurisdiction."

FOOTNOTES

[1] *See* http://www.oecd.org/document/48/0,3343,en_2649_201185_39919216_1_1_1_1,00.html.

[2] *See* Martin B. Tittle, *Permanent Establishment in the United States: A View Through Article V of the U.S.-Canada Tax Treaty* 207-212.

END OF FOOTNOTES

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