A Study of Article XXIX A of the Canada-US Tax Treaty: The Limitation-on-Benefits Article

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PRÉCIS

En 1995, le troisième protocole au traité fiscal entre le Canada et les États-Unis introduisait l'article sur les restrictions apportées aux avantages (article XXIX A) visant à contrer la pratique qui consiste, pour un contribuable, à utiliser la convention la plus avantageuse (« treaty-shopping »). Cette notion renvoie aux situations dans lesquelles les contribuables mettent sur pied des structures artificielles pour bénéficier des taux réduits prévus dans certains traités. Les États-Unis appliqueront unilatéralement l'article sur les restrictions apportées aux avantages pour déterminer le droit des résidents du Canada aux avantages du traité.

Le présent texte résume brièvement l'approche à l'utilisation de la convention la plus avantageuse adoptée par l'Organisation de coopération et de développement économiques et donne un aperçu de la politique américaine sur le sujet, qui a entraîné l'ajout de dispositions sur la restriction des avantages dans tous les traités signés par les États-Unis. La question de la nécessité d'une telle disposition dans le traité fiscal entre le Canada et les États-Unis ainsi que sa nature non réciproque sont également abordées.

L'article XXIX A contient une série de critères d'admissibilité pour aider les États-Unis à déterminer si les résidents canadiens ont droit aux avantages découlant du traité. Les trois premiers critères sont objectifs et portent sur l'admissibilité des personnes, l'exercice (activement) d'activités industrielles ou commerciales et le droit aux avantages découlant du traité. L'auteur précise les exigences dont ces critères sont assortis, y compris les interprétations possibles de divers termes et expressions non définis, et présente des exemples pour illustrer l'application pratique de ces critères dans une situation hypothétique. L'analyse montre que, dans certains cas, un contribuable sans aucune intention d'utiliser la convention la plus avantageuse peut se voir refuser par les États-Unis les avantages découlant du traité. Dans ce cas, le contribuable peut demander que l'on applique un dernier critère subjectif, sous l'obtention d'une décision par l'autorité compétente américaine.

La disposition sur les restrictions apportées aux avantages est, dans certains cas, moins stricte que des dispositions semblables incluses dans d'autres traités fiscaux signés par les États-Unis, mais il reste à voir comment les tribunaux l'appliqueront et comment l'administration fiscale américaine l'interprétera.

ABSTRACT

In 1995, the third protocol to the Canada-US tax treaty introduced the limitation-on-benefits article (article XXIX A) as a means to fight treaty shopping. The concept of treaty shopping refers to situations where taxpayers create artificial structures in order to benefit from the reduced rates available under certain tax treaties. The limitation-on-benefits article will be applied unilaterally by the United States in order to determine entitlement to treaty benefits by residents of Canada.

This essay briefly summarizes the approach to treaty shopping adopted by the Organisation for Economic Co-operation and Development and provides an overview of the United States' policy on the issue, which has led to the insertion of limitation-on-benefits clauses in all tax treaties signed by the United States. The need for the limitation-on-benefits article in the Canada-US treaty is discussed, as well as its non-reciprocal nature.

Article XXIX A provides a series of qualifying tests that will guide the United States in its determination of entitlement to treaty benefits by residents of Canada. The first three tests are objective and establish criteria for qualifying persons, the conduct of an active trade or business, and eligibility for derivative benefits. The requirements of these tests are discussed, including possible interpretations of various undefined terms and expressions, and examples are presented to illustrate the practical application of the tests in a hypothetical case. This analysis reveals that, in some instances, taxpayers with no treaty-shopping intentions may be denied treaty benefits by the United States. In these circumstances, the taxpayer may request the application of a final subjective test, in the form of a ruling by the US competent authority.

Although the limitation-on-benefits article is, in certain instances, less strict than similar provisions incorporated in other tax treaties signed by the United States, it remains to be seen how this article will be interpreted by the courts and applied by the US taxation authorities.

KEYWORDS: TREATY SHOPPING ■ LIMITATIONS ■ BENEFITS ■ TAX TREATIES ■ CANADA/US ■ ANTI-ABUSE

INTRODUCTION

The current Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital (herein referred to as "the Canada-US treaty") was signed at Washington, DC on September 26, 1980. Subsequently, the treaty has been amended through the negotiation of four protocols signed, respectively, on June 14, 1983; March 28, 1984; March 17, 1995; and July 29, 1997. For present purposes, the provisions of the treaty of particular interest are those incorporated in article XXIX A, which was added by article 18 of the third protocol. Article XXIX A is a limitation-on-benefits (LOB) article designed to address the problem of treaty shopping, whereby certain taxpayers gain access to treaty benefits to which they are not properly entitled.

The purpose of this essay is to alert readers to the fact that they or their clients may not be entitled to claim the benefits provided under the Canada-US treaty if they are considered to have created a treaty-shopping structure. To provide a context for the LOB article, I will begin by explaining the international concern over treaty shopping. Specifically, I will identify transactions and/or structures that may be implicated as treaty-shopping arrangements; discuss the underlying reasons for enacting anti-treaty-shopping legislation; discuss the various methods proposed by the Organisation for Economic Co-operation and Development (OECD) to counter treaty shopping; provide an overview of US policy with respect to treaty shopping; and give examples of anti-treaty-shopping provisions previously enacted in the Canada-US treaty. I will continue with a discussion on the need for a limitation-on-benefits clause in the Canada-US treaty, followed by an overview of the structure of the LOB article and a detailed analysis of each of the tests for treaty benefit qualification set out in the article.

It should be noted that the LOB article under review in this essay is unilateral. The United States insisted on inserting the article in the third protocol to the Canada-US treaty in order to deny benefits to taxpayers considered to be treaty shopping through Canada.

THE TREATY-SHOPPING PHENOMENON: WHAT IS IT? HOW CAN WE ELIMINATE IT?

Limitation on Benefits: Fighting Against Treaty-Shopping Structures

What is the motivation lying behind the insertion of a limitation-on-benefits clause in a tax treaty? Why would a contracting state such as the United States insist on a limitation-on-benefits clause when negotiating a tax treaty with another contracting state, namely, Canada? The United States went so far as to terminate its treaty with Malta owing to US government concern over legislative changes in Malta that could make it possible for persons who are not residents of either country to use the treaty.[1]

Generally, a tax treaty is negotiated between two or more contracting states in order to eliminate double taxation and thereby facilitate the exchange of goods and services, and the movement of capital, human capital, etc., across jurisdictional boundaries. With respect to the third protocol of the Canada-US treaty, the principal purpose of the amendments, as stated by the US Senate Foreign Relations Committee, was to promote close economic cooperation between the two countries, to eliminate double taxation of income earned by residents of either country from sources within the other country, to prevent evasion or avoidance of income taxes, and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries.[2] Tax treaties are clearly not intended to facilitate tax evasion or tax fraud. However, in my view, to the extent that tax treaties succeed in eliminating double taxation and thereby promote the competitiveness of countries on an international scale, the number of countries adhering to tax treaties will increase and so too will the risks of abuse through tax evasion or tax fraud. Countries have adopted various mechanisms in order to counter such situations of abuse. The United States has opted for a limitation-on-benefits clause in many of its tax treaties, as will be discussed further below.

The particular instance of tax evasion or tax fraud that is of interest here is the creation of artificial structures by taxpayers in order to benefit from the reduced treaty rates that a contracting state may offer on certain types of income payable to residents of another country that is a signatory to a tax treaty with the contracting state ("the treaty country"). By implementing such a structure, taxpayers can effectively choose to flow their income through the country whose treaty offers the most favourable rate, a practice known as "treaty shopping." Such a structure could consist of interposing a third-party conduit, namely, a resident of the treaty country, to receive income at the reduced treaty rate and subsequently pass it on tax-free, or nearly tax-free, to the ultimate recipient, who is a resident of another country (one that is not a signatory to the treaty).

Consider the following example. A company resident in Brazil earns dividend income from a company resident in the United States (see figure 1). No income tax treaty is in effect between Brazil and the United States at this time. Consequently, any dividend payments made by a resident of the United States to a resident of Brazil are subject to US withholding tax at the rate of 30 percent. Thus, on a dividend payment of $100, the United States will withhold $30 and the resident of Brazil will be left with $70 of dividend income.

If the resident of Brazil decided to interpose a third-party conduit in Canada, it could, in the absence of the LOB article, benefit from the Canada-US treaty as follows (and as shown in figure 2). A dividend payment made by a resident of the United States to a resident of Canada will be subject to US withholding tax at the reduced treaty rate of 5 percent (provided that the resident of Canada is the beneficial owner of at least 10 percent of the voting stock of the US company paying the dividend—otherwise, withholding tax at 15 percent will apply). The resident of Canada will thus have $95 of dividend income, which could be redistributed as a dividend to the resident of Brazil. By virtue of the Canada-Brazil tax treaty, the $95 dividend payment made by the resident of Canada to the resident of Brazil will be subject to Canadian withholding tax at the reduced treaty rate of 15 percent (provided that the beneficial owner of the dividend holds an equity percentage of at least 10 percent in the payer—otherwise, the withholding rate will be 25 percent). The resident of Brazil will thus have $80.75 of dividend income at its disposal.

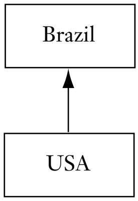
Therefore, through the use of a treaty-shopping structure such as the one discussed above, a resident of Brazil can earn net dividend income of $80.75 by flowing the payment through Canada, as compared with $70 if the payment is received directly from the United States.

As indicated above, the entity used as a flowthrough vehicle is commonly referred to as a "conduit." Writing on the LOB article, Janice Russell has provided the following example of a "direct conduit":

> Consider Aco, a company resident in country A. Aco receives dividends from a company resident in country B, Bco. Aco is a wholly owned subsidiary of a person resident in a third country, C, which does not have a tax treaty with country B. The tax treaty between countries A and B fully or partly exempts Aco from the withholding taxes of country B.[3]

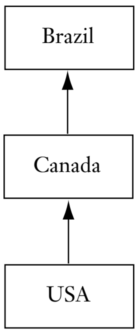
Assume that country A in this example is Canada and country B is the United States. Canada's domestic legislation could exempt Aco from tax in Canada on the

FIGURE 1



	Withholding tax		
	Rate	Amount	Net income
$100 dividend	30%	$30.00	$70.00

FIGURE 2



	Withholding tax		
	Rate	Amount	Net income
$95 dividend	15%	$14.25	$80.75
$100 dividend	5%	$5.00	$95.00
Combined result for $100 dividend	20%	$19.25	$80.75

dividend income received from Bco. For instance, the domestic legislation could use a system for taxing intergroup dividends that would exempt Aco from tax in Canada. Alternatively, the domestic legislation could be based on a territorial taxation system, so that dividends received by Aco's branch located outside Canada would be exempt from Canadian tax. In either case, if the third-country resident elects to create a conduit entity, such as Aco in the above example, and transfers the shares it holds in Bco to it, the third-country resident can obtain benefits available under the Canada-US treaty.

Russell provides the following example of a "stepping-stone conduit":

> Suppose Aco receives interest instead of dividends from Bco. The interest is fully taxable in country A. The resident of country C, however, can reduce the amount of interest taxable in country A to a negligible amount by using debt to finance the company. As a result, Aco pays a high level of interest, thereby significantly reducing the amount of its income taxable in country A.[4]

These examples illustrate the kind of abuse that a limitation-on-benefits clause in a tax treaty aims to remedy. The objective of such a clause is to restrict access to treaty benefits to those who have a sufficient connection to the contracting state from which the benefits are claimed—in other words, to prevent treaty shopping. Goossen has suggested that the tests used to determine the existence of such a connection can be divided into two categories: ownership tests, which depend on the residence of the direct and indirect shareholders of a corporation resident in a contracting state, and activities-based tests, which rely on the presence of a strong economic tie between a contracting state and a corporation resident in that state.[5] Goossen notes that a presumption of treaty shopping may be drawn where income earned by a resident of one contracting state is, to a substantial extent, flowed through to a person who would not qualify for the treaty benefit if the income were earned directly.[6]

As Perry Truster explains,[7] foreign holding companies have historically been used, among other reasons, to reduce overall withholding taxes on dividends by treaty shopping. Anti-treaty-shopping provisions attempt to ensure that the company that receives the dividends is also the ultimate recipient of the dividend income. In other words, if the ultimate recipient of the dividend is a company established in a jurisdiction in which the dividend, had it been received directly, would have been subject to a greater withholding tax rate, the higher withholding tax rate might be levied in any event. Canada has been renegotiating various treaty dividend rates down to 5 percent. In my view, a reduced withholding tax rate with respect to dividends is an excellent incentive for multinational companies to establish themselves in Canada with a view to investing in the United States. In Truster's opinion, many treaty-shopping structures will become much less attractive even if a yet lower rate is theoretically achievable, because of the cost and complexity of establishing and maintaining a foreign holding company that would not be considered to be resident in Canada.

Principles Underlying Treaty-Shopping Provisions

There are several reasons for the inclusion of anti-treaty-shopping rules in a tax treaty. For instance, without such provisions, treaty benefits negotiated between two contracting states could be extended involuntarily to residents of a third country, thereby breaching the principle of reciprocity, the fundamental basis for a treaty of any kind.

As previously mentioned, tax treaties are signed in order to eliminate double taxation. By allowing treaty-shopping structures to exist, treaty countries are effectively allowing third-country residents not only to eliminate double taxation but, in certain circumstances, to exempt themselves from taxation altogether. A further consequence is that while the third-country resident indirectly obtains treaty benefits, its own country of residence is not required to provide reciprocal treaty benefits to either of the two contracting states. In this situation, the third country has little or no incentive to sign tax treaties.[8]

OECD Model Convention

Limitation on Benefits

The OECD model convention[9] does not have a limitation-on-benefits article similar to article XXIX A of the Canada-US treaty. However, the commentary on article 1 of the OECD model convention discusses the circumstances in which the benefits of a convention might be denied to residents engaged in tax-avoidance transactions.[10] This section of the commentary was revised in 1992, following the publication of two reports relating to the use of base companies[11] and conduit companies.[12]

Beneficial Owner Requirement as an Anti-Treaty-Shopping Provision

The OECD model convention relies on the concept of beneficial ownership to eliminate treaty shopping with respect to dividends, interest, and royalties. More particularly, a taxpayer that is resident in a contracting state shall be entitled to the reduced rate provided by a tax treaty to the extent that the taxpayer receiving dividend, interest, or royalty income is the beneficial owner of that income.[13]

Other Approaches

The commentary on article 1 of the OECD model convention describes several other approaches that can be used by contracting states to counter treaty shopping. The commentary suggests that in trying to determine which of the approaches to adopt in their tax treaties, the contracting states should consider the degree to which conduit companies may actually obtain tax benefits, the legal context in both states, and the possibility that bona fide economic activities might unintentionally fall within the ambit of such provisions.[14]

As it is beyond the scope of the present essay to analyze the various suggested approaches, I will limit this discussion to a summary description of each:

- *Lookthrough approach.* Treaty benefits would be denied to a resident of a contracting state if that resident were controlled by persons not resident in that state.[15]
- *Exclusion approach.* Treaty benefits would be denied to residents that benefited from specified local taxes.[16]
- *Subject-to-tax approach.* A resident of one state could not avail itself of treaty protection in respect of income otherwise taxable in the other state unless the income was subject to tax in the person's state of residence.[17]
- *Channel approach.* A company that was resident in one state would be denied treaty benefits in respect of income subject to tax in the other state if persons in a third state had a defined substantial interest in the company and exercised management and control over it, and more than 50 percent of the income was used to satisfy claims of those controlling persons.[18]

The commentary on article 1 also suggests the following relieving provisions in order to ensure that treaty benefits are not inadvertently denied to transactions that are not primarily tax-motivated:

- *A general bona fide provision.* The structure must be motivated by sound business reasons and thus not have as a primary purpose the obtaining of any treaty benefits.

- *An activity provision.* Treaty benefits are not denied in respect of income derived from substantive business operations.
- *An amount-of-tax provision.* Treaty benefits are not denied when the reduction claimed is offset by an equivalent or greater tax burden in the country of residence.
- *A stock exchange provision.* Treaty benefits are not denied to a company if the principal class of its stock or the stock of its parent is listed on a stock exchange in the company's country of residence.
- *An alternative relief provision.* Where treaty benefits are denied to a company resident in one state in respect of income subject to tax in the other state because the company has shareholders in a third state, those benefits will be restored if the third state and the other state have a tax convention that contains provisions that are no less generous.[19]

US Policy on Treaty Shopping

Policy Apparent in Tax Treaties

In 1981, the US Treasury department published a draft model income tax convention containing a limitation-on-benefits clause. Owing to the ensuing controversy, the draft model was eventually withdrawn in 1992. However, in the same year, the United States signed a tax treaty with the Netherlands[20] that included an extensive limitation-on-benefits clause. One commentator suggested that this provision would likely be the basis for a similar clause in the new US model convention that was being drafted by the Treasury department at the time.[21]

US revenue authorities stated that a limitation on benefits clause would be included in all new bilateral tax treaties signed by the United States in order to prevent misuse of those treaties by residents of third countries.[22] Subsequently, during the negotiation of amendments to the Canada-US treaty, the United States insisted that the LOB article be incorporated in the third protocol. US negotiators were undoubtedly mindful that a departure from the stated US policy on this point could have weakened their position in negotiating new treaties and renegotiating existing treaties with other countries.

The inclusion of a limitation-on-benefits clause is now an established component of US tax treaty policy. The last treaty signed by the United States without a limitation-on-benefits provision was the 1979 treaty with Hungary.[23] All treaties ratified by the Senate since 1979 have contained some kind of anti-treaty-shopping provision, as have certain earlier treaties.[24] At the time of writing, the following countries (in addition to Canada) have signed a treaty with the United States containing a limitation-on-benefits provision: Barbados, the Czech Republic, Finland, France, Germany, India, Israel, Kazakhstan, Mexico, the Netherlands, Portugal, Russia, the Slovak Republic, Spain, Sweden, and Tunisia.

When the revised United States Model Income Tax Convention was published on September 20, 1996, it included a limitation-on-benefits clause (article 22). The technical explanation to the model convention states the purpose of limitation-on-benefits provisions as follows:

> The United States views an income tax treaty as a vehicle for providing treaty benefits to residents of the two Contracting States. This statement begs the question of who is to be treated as a resident of a Contracting State for the purpose of being granted treaty benefits. The Commentaries to the OECD Model authorize a tax authority to deny benefits, under substance-over-form principles, to a nominee in one State deriving income from the other on behalf of a third-country resident. In addition, although the text of the OECD Model does not contain express anti-abuse provisions, the Commentaries to Article 1 contain an extensive discussion approving the use of such provisions in tax treaties in order to limit the ability of third state residents to obtain treaty benefits. The United States holds strongly to the view that tax treaties should include provisions that specifically prevent misuse of treaties by residents of third countries. Consequently, all recent U.S. income tax treaties contain comprehensive Limitation on Benefits provisions.[25]

Policy Apparent in Domestic Legislation

The United States' anti-treaty-shopping policy is also reflected in its domestic legislation. An in-depth study of US domestic policy on treaty shopping is beyond the scope of this essay; however, I will briefly discuss a number of statutes that have addressed the issue.

Tax Reform Act of 1986

The Tax Reform Act of 1986 introduced a new branch profits tax. This tax would not apply if it conflicted with an operative treaty provision, unless the non-resident corporation was considered to be treaty shopping. Treaty shopping would be deemed to arise to the extent that the foreign corporation resided in the treaty jurisdiction but had only minimal contacts with that jurisdiction, or if one-half or more of its income was used to meet liabilities to third-country residents.[26]

Bill HR 5270

The Foreign Income Tax Rationalization and Simplification Bill of 1992 (HR 5270)[27] never came to a vote. However, it is interesting to note that Bill HR 5270 proposed limitations on treaty benefits that would have overridden aspects of virtually all US tax treaties, regardless of their effective date. The proposed limitation-on-benefits provision presented two tests, a qualified residence requirement test and a significantly lower tax test. The latter test would have prevented any person from obtaining US tax treaty benefits in respect of income bearing a significantly lower tax under domestic laws of the other treaty country than would have applied on similar income arising from sources within that other country and derived by its residents. In other words, if US-source income bore a significantly lower tax in Canada than would have been the case had the income been derived from a Canadian source, treaty benefits could have been denied. Many countries that had signed tax treaties with the United States, including Canada, registered strong protests against the discriminatory aspects of Bill HR 5270 and its intended unilateral amendment of US tax treaties.[28]

Omnibus Budget Reconciliation Act of 1993

The Omnibus Budget Reconciliation Act of 1993[29] added new section 7701(1) to the Internal Revenue Code.[30] This section of the IRC specifically authorized the enactment of regulations (namely, the conduit regulations under IRC section 7701(1)) that establish a set of rules permitting the recharacterization of a multiparty financing transaction as a transaction existing directly between any two or more parties, where it is determined that such a recharacterization is appropriate in order to prevent avoidance of any tax imposed by the IRC.[31]

IRC Section 894(c)

Regulations issued under IRC section 894 address the eligibility of foreign persons for US tax treaty benefits in respect of payments of US-source investment income received through an entity that is considered "fiscally transparent."[32] The regulations provide, in part, that a foreign person will be entitled to a treaty-reduced rate of withholding tax on US-source investment income if the following conditions are met: the payment is treated as derived by a resident of the applicable treaty jurisdiction; that resident is the beneficial owner of the payment; and all other applicable requirements under the treaty are satisfied. In order for the third condition to be met in the case of the Canada-US treaty, the requirements of the LOB article must be satisfied.[33]

Other Anti-Treaty-Shopping Provisions in the Canada-US Treaty Before the Third Protocol

Even before the introduction of the LOB article, the Canada-US treaty contained several anti-treaty-shopping provisions. For example,

- articles VI through XXIV did not apply to non-resident-owned investment corporations;[34]
- articles VI through XXIV did not apply to certain profits, income, or gains derived by a trust if the principal purpose for the establishment, acquisition, or maintenance of the trust was to obtain treaty benefits;[35] and
- reduced tax rates applicable to income from dividends, interest, and royalties were (and are still) available only if the recipient is the beneficial owner of that income.[36]

INTRODUCTION OF A LIMITATION-ON-BENEFITS CLAUSE IN THE CANADA-US TREATY

Canada as a Potential Tax Haven

It is legitimate to ask whether a limitation-on-benefits clause is necessary in the Canada-US treaty. Treaty shopping generally occurs in countries with low tax rates, whereas Canada does not seem, at first glance, to be a prime location for treaty shoppers. However, certain elements of the Canadian tax system can motivate treaty shopping.

For instance, Canada taxes foreign earnings using an exemption system. Consequently, dividends paid by a foreign affiliate of a corporation resident in Canada become exempt from Canadian taxation if the income is paid out of exempt surplus. Exempt surplus represents a foreign affiliate's net earnings from active businesses carried on in countries with which Canada has signed a tax treaty that is in force and dividends received from other foreign affiliates paid out of exempt surplus.[37] For example, a foreign multinational corporation may have its Canadian subsidiary hold the shares of its other foreign subsidiaries. The dividends paid to the Canadian company out of exempt surplus will not be subject to Canadian tax. In addition, a deferral of tax may be available to the extent that the Canadian company reinvests the dividends in the subsidiaries rather than paying a dividend to its foreign parent.[38]

Application of the LOB Article

As described earlier, in negotiations leading to the signing of the third protocol, the United States insisted that the treaty be amended to include a limitation-on-benefits clause. This clause was added by article XXIX A. The technical explanation prepared by the US Treasury department provides the following general commentary on the application of the LOB article:

> Article XXIX A addresses the problem of "treaty shopping" by requiring, in most cases, that the person seeking U.S. treaty benefits not only be a Canadian resident but also satisfy other tests. In a typical case of treaty shopping, a resident of a third State might establish an entity resident in Canada for the purpose of deriving income from the United States and claiming U.S. treaty benefits with respect to that income. Article XXIX A limits the benefits granted by the United States under the Convention to those persons whose residence in Canada is not considered to have been motivated by the existence of the Convention.[39]

The LOB article will thus be applied by the United States in order to determine whether residents of Canada seeking treaty benefits are entitled to those benefits. The article provides for two types of tests. First, there are three objective tests (safe harbours) dealing with residency and ownership requirements: the qualifying person test, the active trade or business test, and the derivative benefits test. If a taxpayer satisfies the requirements of one of these tests, it can be inferred that there is no underlying treaty-shopping purpose to the transaction, and the taxpayer will thus be entitled to treaty benefits. Second, if the taxpayer does not meet any of the three objective tests, the taxpayer may request the application of a final, subjective test, a review of the claim to entitlement by the US competent authority.

Non-Reciprocal Nature of the Article

As previously mentioned, the LOB article is non-reciprocal; it is to be applied unilaterally by the United States, to determine entitlement to treaty benefits by residents of Canada. Unlike similar provisions in other US treaties, article XXIX A does not provide Canada with any basis on which to deny treaty benefits.[40] Brian Arnold has observed[41] that, with few exceptions, the content of Canada's tax treaties is remarkably consistent. This consistency, in his view, was the underlying reason for Canada's lack of concern with regard to treaty shopping, as well as the fact that the limitation-on-benefits clause in the Canada-US treaty is restricted to the application of the treaty by the United States.

General Anti-Abuse Provisions: Paragraph 7 of Article XXIX A

Paragraph 7 of article XXIX A was included at the request of the Canadian negotiators. It provides that either Canada or the United States has the power to deny treaty benefits to any taxpayer when to do otherwise would result in an abuse of the provisions of the treaty. Thus, as stated in the technical explanation,[42] Canada remains free to apply anti-abuse rules to counter abusive arrangements involving treaty-shopping through the United States, and the United States remains free to apply its substance-over-form and anti-conduit rules in relation to Canadian residents. The principle underlying paragraph 7 is also recognized in the commentary on the OECD model convention, which provides that contracting states may wish to preserve the applicability of their domestic anti-abuse provisions in the context of their bilateral double taxation conventions.[43] The United States and Canada have agreed that the mutual right to deny treaty benefits in abusive situations is inherent in the Canada-US treaty, and their agreement to state this principle explicitly was not intended to suggest that the principle was not also inherent in other tax treaties, including the current Canada-US treaty.

At a panel discussion shortly before the signing of the third protocol, Kevin Dancey of the Department of Finance explained[44] that Canadian authorities were unwilling to adopt a set of mechanical tests that might not be effective in distinguishing between abusive and non-abusive situations. However, there was concern that taxpayers might draw incorrect inferences from the fact that the LOB article would apply only for the purposes of the application of the tax treaty by the United States. More specifically, taxpayers might infer that situations that would have normally been caught by the LOB provisions, had they been applicable by Canada, would be considered acceptable for Canadian purposes, and therefore, in these situations, benefits could not be denied under the Canada-US treaty. Paragraph 7 of article XXIX A was included in order to prevent such inferences from being drawn.

Dancey further stated that the insertion of paragraph 7 in the LOB article should not be viewed as restricting or extending the ability of either jurisdiction to deal with abusive situations.[45] Fellow-panellist Carol A. Dunahoo of the US Treasury department also highlighted the fact that paragraph 7 was to be applied by both Canada and the United States.[46] According to Dunahoo, the US position was that the LOB article did not prevent the United States from applying anti-avoidance rules or from recharacterizing a transaction in accordance with its economic substance.

Interaction of Paragraph 7 and Domestic Anti-Abuse Rules

The technical explanation describes the interaction of the LOB article with a country's anti-abuse provisions as follows:

> While the anti-treaty-shopping rules determine whether a person has a sufficient nexus to Canada to be entitled to treaty benefits, general anti-abuse provisions determine whether a particular transaction should be recast in accordance with the substance of the transaction.[47]

Canada's income tax legislation contains a general anti-avoidance rule, ITA section 245. The general anti-avoidance rule states that when it has been determined that

> a transaction is an avoidance transaction, the tax consequences . . . 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.[48]

The term "avoidance transaction" is defined as a transaction other than one that may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.[49] Finally, tax benefits are not to be denied where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of the ITA or an abuse having regard to the provisions of the ITA (other than the general anti-avoidance rule) read as a whole.[50]

Commenting on the applicability of the general anti-avoidance rule to deny benefits under the Canada-US treaty, Russell has suggested that two interpretations are possible:

> This provision [paragraph 7 of article XXIX A] may be viewed as an anti-avoidance provision itself, so that Canada does not have to rely on the general anti-avoidance rule (GAAR) to deny treaty benefits. A tax treaty is an agreement between two countries. If a treaty permits either country to deny treaty benefits, that by itself could be sufficient grounds for denial.
>
> An alternative view is that Canada must still rely on GAAR to deny treaty benefits. However, it is uncertain whether Canada would be able to apply GAAR to a tax treaty without amending the Income Tax Conventions Interpretation Act, since GAAR is not specifically referred to in that Act. Even if such an amendment were made, it is possible that general principles of treaty interpretation would prevent the application of GAAR.[51]

The US Senate Foreign Relations Committee raised the question whether taxpayers are provided with adequate guidance or certainty, considering that paragraph 7 of the LOB article relies only on internal Canadian law to determine whether a person, otherwise treated as a resident of the United States under article IV of the

Canada-US treaty, is not entitled to treaty benefits in Canada owing to abuse of provisions of the treaty.[52] The committee noted that legislative or judicial developments could change the substance of Canadian tax law as to what constitutes an abuse. However, it also noted that internal rules apply in determining the tax liability of treaty-country residents, and the fact that such rules may change does not result in a weakness in the treaty provisions. Moreover, the OECD commentary recognizes that anti-abuse rules and their underlying principles do not have to be explicitly confirmed in the text of the treaty in order for them to be applicable.[53]

A more detailed discussion of ITA section 245 and its applicability in the context of the Canada-US treaty is beyond the scope of the present essay.

ANALYSIS OF ARTICLE XXIX A

Structure of the Article

Article XXIX A is divided into seven paragraphs. Paragraph 1 deals with the scope of the article. Paragraph 2 defines the concept of a qualifying person. Paragraph 3 details the requirements that must be met in order for a claim for US benefits to qualify under the active trade or business test. Paragraph 4 details the requirements that must be met under the derivative benefits test in respect of US-source dividends, interest, and royalties. Paragraph 5 defines various terms or expressions used in article XXIX A. Paragraph 6 sets out the conditions for qualification for treaty benefits where a request is made to the US competent authority. Finally, as discussed above, paragraph 7 is an anti-abuse provision requested by Canada.

Qualification for Treaty Benefits

Qualifying Person: Paragraphs 1 and 2

Paragraph 1 of article XXIX A provides that, for the purposes of the application of the Canada-US treaty by the United States, only a "qualifying person" shall be entitled to all of the benefits of the treaty, subject to the exception that a non-qualifying person may be entitled to benefits if the requirements of paragraph 3, 4, or 6 are met.

Paragraph 2 defines the term "qualifying person" as follows:

> For the purposes of this Article, a qualifying person is a resident of Canada that is:
>
> (a) A natural person;
>
> (b) The Government of Canada or a political subdivision or local authority thereof, or any agency or instrumentality of any such government, subdivision or authority;
>
> (c) A company or trust in whose principal class of shares or units there is substantial and regular trading on a recognized stock exchange;
>
> (d) A company more than 50 per cent of the vote and value of the shares (other than debt substitute shares) of which is owned, directly or indirectly, by five or fewer persons each of which is a company or trust referred to in subparagraph (c), provided that each company or trust in the chain of ownership is a qualifying person or a resident or citizen of the United States;

(e) (i) A company 50 per cent or more of the vote and value of the shares (other than debt substitute shares) of which is not owned, directly or indirectly, by persons other than qualifying persons or residents or citizens of the United States, or

(ii) A trust 50 per cent or more of the beneficial interest in which is not owned, directly or indirectly, by persons other than qualifying persons or residents or citizens of the United States,

where the amount of the expenses deductible from gross income that are paid or payable by the company or trust, as the case may be, for its preceding fiscal period (or, in the case of its first fiscal period, that period) to persons that are not qualifying persons or residents or citizens of the United States is less than 50 per cent of its gross income for that period;

(f) An estate;

(g) A not-for-profit organization, provided that more than half of the beneficiaries, members or participants of the organization are qualifying persons or residents or citizens of the United States; or

(h) An organization described in paragraph 2 of Article XXI (Exempt Organizations) and established for the purpose of providing benefits primarily to individuals who are qualifying persons, persons who were qualifying persons within the five preceding years, or residents or citizens of the United States.

Each of the eight listed categories and the accompanying requirements are discussed below.

Natural Person

A natural person—that is, an individual—who is a resident of Canada will be entitled to all treaty benefits unless he or she is receiving income on behalf of a third-country resident.[54] In the latter case, treaty benefits may be denied. Because the beneficial owner of the income is the one who must meet the test, an individual who is a resident of Canada is generally not considered a threat for treaty-shopping purposes.[55] Since treaty-shopping schemes generally require the use of a conduit entity, in my view, it is only reasonable to consider that, for the purposes of the LOB article, Canadian-resident individuals will qualify for treaty benefits.

Governmental Entities

Generally, a resident of Canada that is the government of Canada, a political subdivision or local authority thereof, or an agency or instrumentality of any such government, subdivision, or authority will be entitled to all treaty benefits.[56] However, in the event that any such governmental entity is receiving income on behalf of a third-country resident, treaty benefits may be denied. Again, because it is the beneficial owner of the income that must meet the test, governmental entities resident in Canada are not considered a threat for treaty-shopping purposes.[57]

Since one of the motivating factors for two countries to negotiate a tax treaty is to promote closer economic cooperation between them, it is only appropriate for one contracting state to have faith that the other contracting state and its governmental entities will not attempt to abuse the treaty for their own advantage.

Publicly Traded Company or Trust

A company or trust that is a resident of Canada and whose principal class of shares or units is substantially and regularly traded on a recognized stock exchange will be considered a qualifying person and will therefore be entitled to all treaty benefits.[58] In most cases, a publicly traded company or trust should not pose a treaty-shopping threat to the United States. In my view, the regulatory requirements that must be complied with by publicly traded companies or trusts resident in Canada would serve as a strong deterrent from using such an entity for treaty-shopping purposes.

Several terms used in paragraph 2(c) of article XXIX A will be examined below. In the case of those terms that are not defined in the Canada-US treaty, or where there are conflicting interpretations for the term in question, qualification for treaty benefits will depend initially on the judgment of the US tax authorities, subsequently on the US competent authority, and perhaps ultimately on the US judicial corps.

Principal Class of Shares

The term "principal class of shares" is not defined in the Canada-US treaty. The same term is, however, used and defined in the US-Netherlands treaty,[59] and that source can be a useful tool in the present analysis.

Under the US-Netherlands treaty, the "principal class of shares" represents 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. In the event that no single class of shares represents the majority of the voting power and value of the company, the treaty provides that the principal class of shares shall be those classes of shares that, in aggregate, possess more than 50 percent of the voting power and value of the company. In the determination of voting power, any shares or classes of shares that have been authorized but not issued should be excluded. In addition, appropriate weight should be given to any restrictions or limitations on voting rights of issued shares, by mutual agreement of the competent authorities.[60]

The US-Netherlands treaty further states that the principal class of shares also includes any disproportionate class of shares, namely, any class of shares of a company resident in one contracting state entitling the shareholder to disproportionately higher participation in the earnings generated in the other contracting state by particular assets or activities of the company.[61]

Applying the public trading test in the Canadian context, Russell identifies the following share structure, commonly used in Canada in order to retain control of a public corporation within a family group, as an example of a company that will not qualify:

> [A] company that has issued class A voting shares and class B non-voting shares will not meet the publicly traded test if the class A shares are privately held and only the class B shares are publicly traded.[62]

The company fails the test because the principal class of shares—the class A shares—is not substantially and regularly traded on a recognized stock exchange. However, the structure may qualify under another test.

Substantial and Regular Trading

The term "substantial and regular trading" also is not defined in the Canada-US treaty, and again, the US-Netherlands treaty offers some guidance.

Under that treaty, the shares of a particular class will be considered substantially and regularly traded on a recognized stock exchange within a taxable year if two conditions are met.[63] First, trades must be effected on a recognized stock exchange other than in de minimis quantities during every month. What constitutes a "de minimis" quantity, for the purpose of qualification for treaty benefits, appears to be open to interpretation. Second, the aggregate number of shares in the class of shares in question that was traded on a recognized stock exchange during the previous taxable year must be at least 6 percent of the average number of shares outstanding in that class during that taxable year. Finally, the definition specifies that any pattern of trades effected in order to qualify under this test will be disregarded.

Recognized Stock Exchange

The term "recognized stock exchange" is defined in paragraph 5(a) of article XXIX A to mean

- the NASDAQ 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 (namely, the New York Stock Exchange, the American Stock Exchange, and other major US stock exchanges);
- Canadian stock exchanges that are "prescribed stock exchanges" under the ITA (namely, the Montreal Stock Exchange, the Toronto Stock Exchange, the Winnipeg Stock Exchange, and the Canadian Venture Exchange, which has resulted from a merger of the Alberta Stock Exchange and the Vancouver Stock Exchange);[64] and
- any other stock exchange agreed upon by Canada and the United States in an exchange of notes or by their respective competent authorities.[65]

Under the US-Netherlands treaty, this term includes the US exchanges listed above (with the exception of the NASDAQ in respect of closely held companies), the Amsterdam Stock Exchange, and any other stock exchange agreed upon by the competent authorities of the two countries. The Netherlands and the United States have agreed that, for the purposes of their treaty, the stock exchanges of Brussels, Frankfurt, Hamburg, London, Madrid, Milan, Paris, Sydney, Tokyo, and Toronto shall be considered recognized stock exchanges. According to Russell,

> [b]y agreeing to expand the list of recognized stock exchanges, the United States appears to agree that a company is not likely to have been established primarily for a tax-avoidance purpose if its shares are substantially traded on a recognized stock exchange, even if the exchange is located in neither the United States nor the Netherlands.
>
> The United States may be less willing to expand the list of recognized stock exchanges for purposes of the Canada-US treaty. The publicly traded test in the US-Netherlands treaty does not apply to conduit companies unless they meet a base erosion test. The publicly traded test in the protocol does not include similar anti-abuse provisions.[66]

These additional anti-abuse provisions in the US-Netherlands treaty will be discussed below. However, at this point, I will note that a more lenient LOB article in the Canada-US treaty is advantageous to Canada since it may be considered an incentive by taxpayers seeking to establish their businesses here.

Subsidiary of a Publicly Traded Company or Trust

In the event that a company does not qualify under the publicly traded company test, it may still be considered a qualifying person if certain other criteria are met.[67] More specifically, a non-publicly traded subsidiary of a publicly traded company or trust will be considered a qualifying person to the extent that the requirements of the ownership test are fulfilled, as described below.

Ownership Test

For a subsidiary to qualify under this test, more than 50 percent of the vote and value of the shares in question (other than debt substitute shares) must be owned, directly or indirectly, by five or fewer persons, each of which qualifies as a publicly traded company or trust, and each company or trust in the chain of ownership must be a qualifying person or a US resident or citizen. If, for example, Subco is owned by three qualifying publicly traded companies resident in Canada (Publico 1, Publico 2, and Publico 3 owning, respectively, 10 percent, 30 percent, and 15 percent of the vote and value of Subco) and a private company holding the remaining vote and value (45 percent) of Subco, Subco will qualify for benefits under the Canada-US treaty.

■ *Debt Substitute Share Exception*

As mentioned above, in the determination of a company's ownership, debt substitute shares are to be excluded. The term "debt substitute share" is defined in paragraph 5(c) of article XXIX A to mean a share described in paragraph (e) of the definition "term preferred share" in the ITA[68] (also known as a distress preferred share) or any other type of share agreed upon by the Canadian and US competent authorities.

Briefly, the ITA defines a distress preferred share as a share issued by a corporation residing in Canada, for a period not exceeding five years from the date of issue, further to a proposal in bankruptcy; or where 90 percent or more of the company's assets have been sequestered; or where, owing to financial difficulties, the issuing corporation has defaulted on a commitment. In other words, a distress preferred share is a share received in a debt-restructuring arrangement undertaken by reason of financial difficulty or insolvency.

■ *Chain of Ownership*

As noted above, under article XXIX A of the Canada-US treaty, in order for a subsidiary company or trust to qualify, each company or trust in the chain of ownership must be a qualifying person or a resident or citizen of the United States. The technical explanation provides the following example:

> [A] Canadian company that is not publicly traded but that is owned, one-third each, by three companies, two of which are Canadian resident corporations whose principal classes of shares are substantially and regularly traded on a recognized stock exchange, will qualify under subparagraph (d).[69]

Examples provided by Russell illustrate the effect of the chain-of-ownership test:

> Consider a company resident in Canada, Aco, which purchases the shares of a company resident in Hong Kong, Bco, which has a wholly owned subsidiary resident in Canada, Cco. The principal class of Aco's shares is substantially and regularly traded on the Toronto Stock Exchange. In this case, Cco would not be a qualifying person for purposes of the protocol. Although Cco is indirectly owned by Aco, Bco is not a qualifying person or a resident or citizen of the United States. Consequently, Aco would have to liquidate Bco, for example, to make Cco a qualifying person. Alternatively, Cco may be a qualifying person if it meets the active business test described below. Further, Cco could request that the competent authority grant the benefits of the treaty.
>
> Suppose that a group of six companies resident in Canada incorporates another company resident in Canada, Aco, to carry on joint venture activities on behalf of the group. Five of the companies meet the publicly traded test. Together, they own 40 percent of the vote and value of Aco. The sixth shareholder is a private corporation. This company holds the remaining shares of Aco. In this case, to be a qualifying person, Aco would have to rely on another test, such as the ownership and base erosion test [under paragraph 2(e) of article XXIX A, discussed below, relating to the qualification of a company or trust as a qualifying person].[70]

An ownership test is also included in the US-Netherlands treaty.[71] The technical explanation to that treaty indicates that share ownership will be determined under IRC section 883(c)(4). As a result, stock owned, directly or indirectly, by or for a corporation, partnership, trust, or estate will be treated as if it were owned proportionately by its shareholders, partners, or beneficiaries.

Noted Differences

The Senate Foreign Relations Committee noted the absence of a base erosion test with respect to a subsidiary of a publicly traded company or trust in the Canada-US treaty as opposed to other US tax treaties. Such a requirement is generally present in order to limit potentially abusive structures.[72]

The US-Netherlands treaty contains provisions that can be regarded as attempts to prevent abuse, according to the Senate report.[73] While treaty benefits may be afforded to wholly owned subsidiaries of publicly traded companies and joint ventures of publicly traded companies, such entities must meet one of two additional tests that measure base erosion. Under the treaty, a conduit company is one that pays out at least 90 percent of its aggregate receipts that are deductible payments (inclusive of royalties and interest, but exclusive of arm's-length payments for tangible property in the ordinary course of business or services performed in the payer's country of residence).[74] Either the company is not a conduit, or if the company is a conduit, it must meet a conduit company base reduction test.[75] The latter test will be met to the extent that less than a threshold fraction (generally 50 percent) of the company's gross income is paid to associated enterprises subject to a particularly low tax rate (in relation to the tax rate normally applicable in the payer's country of residence).[76]

It was further noted by the Senate that a provision comparable to the one in the US-Netherlands treaty exists in the US domestic law with respect to branch profits tax. For purposes of that tax, only a wholly owned subsidiary of a publicly traded company that is organized under the laws of the same country may be treated as a "qualifying resident" of its country of residence. Therefore, it appears that article XXIX A of the Canada-US treaty is less stringent than US tax policy under both domestic law and other treaties.[77]

Company or Trust

A company or trust that is not publicly traded may still be a qualifying person for purposes of article XXIX A if it meets additional ownership and base erosion tests,[78] described below. Thus, subject to these tests, a privately held company or an unlisted trust may be entitled to treaty benefits.

Ownership Test

The ownership test provides a lookthrough mechanism to determine the ultimate beneficial owners of an entity. While the test is similar for both a company and a trust, different issues arise in each case with respect to the application of the test.

■ *Company*

A company will meet the ownership test if 50 percent or more of the vote and value of the shares (other than debt substitute shares)[79] is not owned, directly or indirectly, by persons other than qualifying persons or US residents or citizens. It may have been simpler to state that 50 percent or more of the vote and value of the shares (other than debt substitute shares) must be owned, directly or indirectly, by persons other than qualifying persons or US residents or citizens. The following example is offered in the technical explanation in order to clarify the underlying intention of the negative wording:

> [I]f a Canadian company is more than 50 percent owned by a U.S. resident corporation that is, itself, wholly owned by a third-country resident other than a U.S. citizen, the Canadian company would not pass the ownership test. This is because more than 50 percent of its shares is owned indirectly by a person (the third-country resident) that is not a qualifying person or a citizen or resident of the United States.[80]

Russell explains that the result of this negative wording is that the status of any company or trust as a qualifying person within the chain of ownership will depend upon whether any owner higher in the chain is not a qualifying person or a US resident or citizen. She goes on to give an example of how this negative wording can affect the status of a company within the chain of ownership:

> For example, a company resident in Canada, Aco, may be a wholly owned subsidiary of another company, Bco, which is a resident of the United States. However, if more than 50 percent of Bco's vote and value are held by a resident of the Cayman Islands, Aco will not be a qualifying person.[81]

The Senate Foreign Relations Committee considered that any abuses in this area would be addressed by the general anti-abuse provisions in paragraph 7 of article XXIX A.[82]

■ *Trust*

In the case of a trust, the ownership test will be met if 50 percent or more of the beneficial interest is not owned, directly or indirectly, by persons other than qualifying persons or residents or citizens of the United States.

According to Russell, the ownership test may be difficult to apply to a trust.[83] In fact, how is the beneficial interest to be measured when the beneficiaries have disproportionate rights in the trust? Russell suggests calculating the fair market value of those rights using actuarial methods. It remains to be seen how this situation will be resolved by the US competent authority.

Another issue raised by Russell is the changing of residence by a beneficiary owning more than 50 percent of the beneficial interest in the trust.[84] If such a beneficiary were to become a resident of a country other than Canada or the United States, a trust that is a qualifying person or a corporation whose shares are owned by a trust could lose its entitlement to any treaty benefits. Russell suggests examining the possibility of varying the terms of the trust or of transferring interests in the trust in order to avoid such an outcome.

Base Erosion Test

The base erosion test provides that the amount of expenses deductible from gross income that are paid or payable by the company or trust during the fiscal period under review to persons other than qualifying persons or US residents or citizens, must be less than 50 percent of the gross income of the company or trust for that period. The purpose of this test is to prevent a company or trust that meets the ownership test described above from serving as a conduit through which a significant amount of its income is distributed to persons that are not entitled to the benefits under the treaty.

■ *Gross Income*

The term "gross income" is not defined in the Canada-US treaty, and one must therefore refer to domestic legislation for the proper meaning. In US domestic tax law, gross income is defined as gross receipts less the cost of goods sold.[85]

■ *Expenses Deductible from Gross Income*

The US Treasury department has indicated that the following expenses would not be deductible from gross income and would therefore be irrelevant for the purposes of the base erosion test:[86] the purchase of raw materials for use in the corporation's manufacturing activities (these expenses would be included in the cost of goods sold) and rental payments for factory premises.

■ *Expenses Paid or Payable to Persons Other than Qualifying Persons or US Residents or Citizens*

Expenses that are paid or payable to persons other than qualifying persons or US residents or citizens may lead to loss of treaty benefits. A company must therefore ensure that the suppliers and/or creditors with which it does business do not fall under this category. Suppose, for example, that a company has a significant amount of debt owing to the Canadian subsidiary of a foreign bank, which is neither a qualifying person nor a US resident or citizen. The company could fail the base erosion test because it did not select a Canadian bank as its lender.

■ *Fiscal Period Under Review*

The fiscal period under review with respect to the base erosion test is the preceding fiscal period of the company or trust. In the event that the company or trust is at its first fiscal period, the period under review is that period.

An example will help to explain the application of this concept. Assume that the fiscal period of Canco (a corporation resident in Canada) coincides with the calendar year and that Canco's first fiscal period occurs in 2001. If Canco meets the requirements of the base erosion test in its first fiscal period (2001), it will be entitled to all treaty benefits. If, however, Canco fails this test in 2001 and subsequently meets it in the course of its second fiscal period (2002), Canco must wait until the third fiscal period (2003) in order to be considered a qualifying person and consequently entitled to all treaty benefits. This result is explained by the fact that the fiscal period under review is the preceding fiscal period.

Example

The technical explanation states the following with regard to the above tests:

> The ownership/base erosion test recognizes that the benefits of the Convention can be enjoyed indirectly not only by equity holders of an entity, but also by that entity's obligees, such as lenders, licensers, service providers, insurers and reinsurers, and others. For example, a third-country resident could license technology to [a] Canadian-owned Canadian corporation to be sublicensed to a U.S. resident. The U.S. source royalty income of the Canadian corporation would be exempt from U.S. withholding tax under Article XII (Royalties) of the Convention (as amended by the Protocol). While the Canadian corporation would be subject to Canadian corporation income tax, its taxable income could be reduced to near zero as a result of the deductible royalties paid to the third-country resident. If, under a Convention between Canada and the third country, those royalties were either exempt from Canadian tax or subject to tax at a low rate, the U.S. treaty benefit with respect to the U.S. source royalty income would have flowed to the third-country resident at little or no tax cost, with no reciprocal benefit to the United States from the third country. The ownership/base erosion test therefore requires both that qualifying persons or U.S. residents or citizens substantially own the entity and that the entity's deductible payments be made in substantial part to such persons.[87]

Noted Differences

The ownership requirement differs from that in other treaties signed by the United States in two respects. First, although in the US-Netherlands treaty,[88] for example, qualification is determined in part by compliance with ownership and base erosion tests, the Canada-US treaty differs in expressing this requirement in the negative. Consequently, intervening tiers of companies are also treated as qualifying persons, or not, by reference to the ultimate beneficial owners.[89]

Second, it was noted by the Senate Foreign Relations Committee that the vote and value test was drafted to apply in the aggregate rather than to each class. Under the treaty signed with Germany, the vote and value test must be applied in respect of each class of the entity's shares. Under treaties with Israel and the Netherlands, the test is applied by reference to the aggregate votes and values represented by all classes of shares, and anti-abuse provisions are inserted to prevent avoidance of the requirements by issuing classes of shares bearing rights that achieve disproportionate allocations among taxpayers. It was stated that since no specific anti-abuse rules were provided in the Canada-US treaty, any abuse with respect to this test would be addressed by the general anti-abuse provisions in paragraph 7 of article XXIX A.[90]

Estate

An estate resident in Canada will be considered a qualifying person and will therefore be entitled to all treaty benefits.[91] Under US domestic tax law, an estate does not include a testamentary trust.

Thus, a Canadian-resident estate that holds shares of a US company will be a qualifying person even if the sole beneficiary is a Hong Kong resident.[92]

Not-for-Profit Organization

A not-for-profit organization will be considered a qualifying person and will therefore be entitled to all treaty benefits if more than half of all beneficiaries, members, or participants of the organization are qualifying persons or US residents or citizens.[93] As defined in paragraph 5(b) of article XXIX A, a "not-for-profit organization" of a contracting state is

> an entity created or established in that State and that is, by reason of its not-for-profit status, generally exempt from income taxation in that State, and includes a private foundation, charity, trade union, trade association or similar organization.

Exempt Organization

Finally, an organization described in paragraph 2 of article XXI (Exempt Organizations)—namely, a company or trust established to provide pension, retirement, or other employee benefits—will be considered a qualifying person and will therefore be entitled to all treaty benefits.[94] The organization must be established for the purpose of providing benefits primarily to individuals who are qualifying persons, persons who were qualifying persons within the five preceding years, or US residents or citizens.

A registered retirement savings plan (RRSP) or other type of individual retirement account will be considered a qualifying person if the above conditions are met. According to the technical explanation, a Canadian RRSP of a former resident of Canada who is working temporarily outside Canada will continue to qualify during the period of the individual's absence from Canada or for five years, whichever is shorter.[95] Therefore, in the case of a Canadian-resident individual who becomes a non-resident of Canada on January 1, 2001 owing to a temporary work assignment abroad, the individual's RRSP will continue to qualify as an exempt organization until December 31, 2005.

Also according to the technical explanation, a Canadian pension fund established to provide benefits to employees of a company is a qualifying person to the extent that most of the beneficiaries of the fund are, or were within the preceding five years, individual residents of Canada or US residents or citizens.[96] It is my understanding that the expression "most beneficiaries" refers to a simple majority, namely, 50 percent + 1 of the total beneficiaries. Therefore, assuming that a Canadian pension fund is established to provide benefits to the 50 individuals employed by company X, in order for the fund to qualify as an exempt organization, at least 26 of those 50 employees must be, or have been in the last five years, Canadian-resident individuals or US residents or citizens.

Active Trade or Business Test: Paragraph 3

Paragraph 3 of article XXIX A provides that a person that is a resident of Canada but not a qualifying person pursuant to paragraph 2, or a person related thereto, may be entitled to treaty benefits provided that that person is engaged in the active conduct of a trade or business in Canada. It appears that when a person qualifies for treaty benefits under one of the tests provided under paragraph 2, no further inquiries will be made to determine whether that person qualifies under paragraph 3. Accordingly, when a person qualifies under paragraph 2, the beneficial owner shall be entitled to treaty benefits in respect of any income derived from the other contracting state.[97]

Under the active trade or business test, where a Canadian resident is engaged in the conduct of an active trade or business in Canada, treaty benefits will be limited to income derived from the United States in connection with or incidental to that trade or business, including any such income derived directly or indirectly by the Canadian resident through one or more other persons that are residents of the United States. More simply stated, if a person who is a resident of Canada is engaged in an active trade or business in Canada, and derives US-source income in connection with that business, the person is entitled to US tax benefits under the treaty in respect of that income.

The active trade or business test must be applied with respect to each type of US-source income earned by a resident of Canada that is not a qualifying person.[98] A person must qualify under this test for each type of income since the benefits will be allowed only for those types of income meeting the requirements of the test.

If a corporation resident in Canada, Canco, does not qualify for treaty benefits under one of the "qualifying person" tests discussed above, it may still qualify for treaty benefits under the active trade or business test. In accordance with this test, Canco must be engaged in an active trade or business in Canada. In the event that Canco earns US-source income in connection with its active trade or business in Canada, Canco may claim treaty benefits with respect to that US-source income. If, however, Canco earns more than one type of US-source income in connection with its active trade or business in Canada, the specific criteria of the test (which are discussed below) will need to be met for each type of income.

As stated in the technical explanation, unlike the other tests, the active trade or business test focuses not only on the characteristics of the person deriving the income, but also on the nature of the activity engaged in by that person and the connection between the income and that activity.[99] I will now examine the specific criteria that must be complied with in order for a Canadian resident to qualify under this test.

Related Person

According to the technical explanation, the principles of IRC section 482 will apply in determining whether a person is related to another person.[100] Pursuant to IRC section 482, related parties are any two or more organizations, trades, or businesses (whether or not incorporated, organized in the United States, or affiliated) that are owned or controlled directly or indirectly by the same interests. An organization includes an organization of any kind, whether a sole proprietorship, partnership, trust, estate, association, or corporation. Russell has observed that the facts and circumstances of each particular case will have to be examined in order to determine whether two parties are related or not.[101]

It should be noted that the possibility of entitlement to treaty benefits under this test via a related person is not common in other US tax treaties.[102] For instance, with respect to the limitation-on-benefits clause of the US-Netherlands treaty, an elaborate set of attribution rules is provided. The report of the Senate Foreign Relations Committee states that "the active business test takes into account the extent to which the person seeking treaty benefits either is itself engaged in business, or is deemed to be so engaged through the activities of related persons."[103] Under the Canada-US treaty, the test could be met by the person seeking treaty benefits if the active trade or business was carried on by a related person, or if the income earned in connection therewith was received indirectly through a related person.

Active Trade or Business

The term "active trade or business" is not defined in the Canada-US treaty. However, the US-Netherlands treaty provides some guidance on this matter.[104] According to the technical explanation of the latter treaty, the US competent authority will refer to the regulations issued under IRC section 367(a).

Pursuant to those regulations, a "trade or business" is a specific unified group of activities that constitute (or could constitute) an independent economic enterprise carried on for profit. In order to constitute a trade or business, a group of activities must ordinarily include every operation that forms part of, or a step in, a process by which an enterprise may earn income or profit. Also, the group of activities must ordinarily include the collection of income and the payment of expenses.[105]

With respect to the meaning of "active" conduct of a trade or business, the regulations state that a corporation actively conducts a trade or business only to the extent that the officers and employees of the corporation carry out substantial managerial and operational activities. For these purposes, officers and employees of the corporation are considered to include those of related entities who are made available to and supervised day-to-day by, and whose salaries are paid by, a related corporation.[106]

A more in-depth study of the regulations is required for an understanding of what is considered "substantial managerial and operational activities." However, for the purposes of the LOB article, it may be presumed that, to the extent that a company resident in Canada is engaged in legitimate business activities for the purpose of earning a profit, that company should qualify for treaty benefits.

Non-Qualifying Business Activities

Paragraph 3 states that, in order to qualify, the trade or business in question must be 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.

Income Derived in Connection with or Incidental to an Active Trade or Business

To the extent that a company resident in Canada is engaged in an active trade or business in Canada, treaty benefits can be claimed with respect to income derived from the United States in connection with or incidental to that trade or business. Article XXIX A does not define or further elaborate on the expression "income derived . . . in connection with or incidental to that trade or business"; however, the technical explanation provides some guidance on how it is to be interpreted.

In Connection with an Active Trade or Business

According to the technical explanation, income will be considered to be derived "in connection" with an active trade or business in the United States if, for example, the income-generating activity in the United States is "upstream," "downstream," or parallel to the income-generating activity conducted in Canada.[107] I find this explanation to be somewhat confusing. However, the following example is also provided:

> [I]f the U.S. activity 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.[108]

In other words, if Canco (a company resident in Canada) is in the business of manufacturing radiators in Canada and earns US-source income from the sale of the radiators in the United States, this income should be considered to be derived in connection with Canco's trade or business in Canada. Similarly, if Canco has a branch manufacturing radiator tubes in the United States, which will later be sold to Canco and used in the radiator manufacturing process in Canada, the income earned in the United States from the sale of the tubes to be used in Canco's manufacturing activities in Canada should also be considered to be derived in connection with Canco's trade or business in Canada.

The US-Netherlands treaty specifies that income is derived in connection with an active trade or business if the income-producing activity in the other contracting state is a line of business that forms a part of or is complementary to the trade or business conducted in the first contracting state by the income recipient.[109]

Incidental to an Active Trade or Business

According to the technical explanation, income will be considered "incidental" to the active conduct of a trade or business in Canada if, for example, it arises from the short-term investment of working capital of the Canadian resident in US securities.[110]

The US-Netherlands treaty specifies that income will be considered incidental to a trade or business if the income facilitates the conduct of the trade or business.[111]

Income Derived Directly or Indirectly Through One or More US-Resident Persons

An item of income can be considered to be earned in connection with or incidental to an active trade or business in Canada if the income is derived directly by the resident of Canada claiming the benefits, or indirectly through one or more US-resident persons. The technical explanation goes on to specify that a Canadian resident may claim treaty benefits with regard to income earned by an operating US subsidiary if the income is derived by the Canadian resident indirectly through a wholly owned US holding company interposed between it and the operating subsidiary.[112] A Canadian resident may also earn income through one or more US residents that it does not wholly own. The technical explanation provides the following example:

> [A] Canadian partnership in which three unrelated Canadian companies each hold a one-third interest could form a wholly-owned U.S. holding company with a U.S. operating subsidiary. The "directly or indirectly" language would allow otherwise available treaty benefits to be claimed with respect to income derived by the three Canadian partners through the U.S. holding company, even if the partners were not considered to be related to the U.S. holding company under the principles of Internal Revenue Code section 482.[113]

Substantiality Test

A further requirement in respect of US-source income derived in connection with or incidental to an active trade or business in Canada is that the trade or business must be "substantial" in relation to the income-generating activity carried on in the United States. The Canada-US treaty does not indicate what may be considered a substantial trade or business. According to the technical explanation, the Canadian trade or business does not necessarily need to be as large as the US income-generating activity. However, it also should not represent "only a very small percentage" of the size of the US activity in terms of income, assets, or other similar measures.[114]

According to the technical explanation, the underlying purpose of the substantiality requirement is the prevention of treaty shopping. The following example is provided:

> [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 of the Convention, as amended by the Protocol. 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.[115]

The US-Netherlands treaty provides a test designed to determine whether a trade or business is substantial.[116] In the application of this test, the following factors will need to be examined: (1) the proportionate share of the trade or business in the other state, (2) the nature of the activities performed, and (3) the relative contributions made to the conduct of the trade or business in both states. The US-Netherlands treaty also provides that a trade or business will be deemed substantial if certain ratios are met regardless of the above-mentioned factors. The specified ratios are based on a comparison of the value of assets used, gross income, and payroll expense in the two countries. Each ratio must exceed 7.5 percent for the preceding year, and the average of the three ratios must exceed 10 percent for a given year.

It remains to be seen what measures of substantiality will be used with regard to the Canada-US treaty.

Derivative Benefits Test: Paragraph 4

Paragraph 4 of article XXIX A provides that a company that is a resident of Canada but does not meet one of the tests in paragraphs 2 and 3 may still qualify for treaty benefits in respect of dividends, interest, and royalties, provided that the ownership and base erosion tests described below are met. The basis for allowing derivative benefits is that, if similar benefits could have been obtained by the owners of an entity, their use of the entity could not have been motivated by the principal purpose of obtaining treaty benefits. Similarly, deductible payments made to a third-country resident that is entitled to substantially similar treaty benefits with respect to such payments arguably should not count as an abusive reduction of income under the base erosion test.[117]

Ownership Test

The ownership test requires that more than 90 percent of the aggregate vote and value of all the company's shares (other than debt substitute shares)[118] be owned, directly or indirectly, by a qualifying person, a US resident or citizen, or a person who satisfies the three tests described below.

For example, assume that Canco is a company resident in Canada but does not qualify for treaty benefits under either the qualifying person tests or the active trade or business test. However, more than 90 percent of the aggregate vote and value of Canco's shares is owned by a qualifying person. Canco can therefore claim treaty benefits with respect to dividends, interest, and royalties.

Other Persons

Where more than 90 percent of the aggregate vote and value of the company's shares is owned by a person other than a qualifying person or a US resident or citizen ("the other person"), the following three tests must be met in order to satisfy the ownership requirements:

1. The other person must be a resident of a third country with which the United States has a comprehensive income tax treaty and must be entitled to all of the benefits provided by the United States under that treaty. Thus, for example, if the other person does not meet the requirements of a limitation-on-benefits clause in that treaty, the person will not be entitled to benefits under the derivative benefits test in the Canada-US treaty. In addition, qualification under an active trade or business test will not be sufficient since such a test grants benefits only for certain items of income, not for all purposes of the treaty.[119]

   In some circumstances, the third country in question may not have a limitation-on-benefits clause in its treaty with the United States, or the existing limitation-on-benefits clause may contain less strict rules. With respect to this issue, the Joint Committee on Taxation proposes that, if the United States allows residents of third countries to claim benefits from one of its treaties, it should allow such derivative benefits only in cases where the benefits that a third-country resident could claim under its own treaty with the United States are no more favourable than the ones available under a derivative benefits provision, in order to avoid potential abuses.[120]
2. The other person must be a person that would qualify for benefits either as a qualifying person or under the active trade or business test if that person were a resident of Canada and, for the purposes of the active trade or business test, if the business it carried on in the country in which it is a resident were carried on by it in Canada. The technical explanation provides the following example:

   > [A] person resident in a third country would be deemed to be a person that would qualify under the publicly-traded test of paragraph 2 of this Convention if the principal class of its shares were substantially and regularly traded on a stock exchange recognized either under the treaty between the United States and Canada or under the treaty between the United States and the third country. Similarly, a company resident in a third country would be deemed to satisfy the ownership/base erosion test of paragraph 2 under this hypothetical analysis if, for example, it were wholly owned by an individual resident in that third country and most of its deductible payments were made to individual residents of that country (i.e., it satisfied base erosion).[121]
3. The other person must be entitled to a rate of US withholding tax under the treaty between that person's country of residence and the United States, in respect of the particular class of income for which benefits are being claimed

under the Canada-US treaty, that is at least as low as the rate applicable under the Canada-US treaty.

Base Erosion Test

The base erosion test matches the test, described above, that is provided in paragraph 2(e) of article XXIX A relating to the qualification of a company or trust as a qualifying person. That is, the amount of expenses deductible from gross income that are paid or payable by the company for the fiscal period under review to persons that are not qualifying persons or US residents or citizens must be less than 50 percent of the gross income of the company for that period. For a review of the components of this test, see the previous discussion under the heading "Qualifying Person—Company or Trust—Base Erosion Test."

Example

Russell provides the following example to illustrate the application of the derivative benefits test:

> Consider . . . a company resident in Canada that is owned by a company resident in a third country. Assume that the principal class of shares of the latter company is substantially and regularly traded on a stock exchange recognized under the treaty between the United States and the third country. The company resident in Canada would satisfy the derivative benefits test if it met the base erosion test described above. Alternatively, if the company resident in a third country met an active business test included in the limitation-on-benefits article in that country's treaty with the United States, the Canadian company would not satisfy the derivative benefits test. This would be the case because the active business test permits treaty benefits to be applied to only certain types of income. Therefore, not all the benefits of the treaty between the third country and the United States would be available. If a company did not meet the derivative benefits test because the treaty rate on dividends between the third country and the United States is 10 percent, for example, instead of 5 percent, US withholding tax would be exigible at the maximum rate of 30 percent, not the reduced rate of 10 percent.[122]

Noted Differences

The inclusion of the derivative benefits test in the Canada-US treaty is an exception to usual US treaty practice. According to the technical explanation, this test was included in the LOB article because of the special economic relationship between the United States and Canada, as well as the close coordination between the two tax administrations.[123]

In contrast to those US treaties that do provide for a similar test (that is, treaties with the Netherlands, Mexico, Jamaica, and France), the derivative benefits test in the Canada-US treaty does not require same-country ownership of the Canadian corporation seeking treaty benefits.[124] As discussed above, a company resident in Canada whose shares are owned by a person other than a qualifying person or a US resident or citizen may be owned by a resident of a third country that satisfies the three ownership requirements.

As mentioned above, a person may qualify for benefits under the derivative benefits test by satisfying the active trade or business test, which entitles a person to benefits with respect to income derived in connection with or incidental to a business. It appears that the United States has the power to deny treaty benefits to any portion of the Canadian resident's income not derived in connection with or incidental to an appropriate business (one that qualifies under the active trade or business test).[125]

US Competent Authority: Paragraph 6

In the event that a resident of Canada does not qualify for treaty benefits under one of the preceding objective tests, paragraph 6 of article XXIX A provides for recourse to the US competent authority. When requested, the US competent authority is to determine whether treaty benefits should be granted in the particular case, taking into account all factors, including the history, structure, ownership, and operations of the person, in relation to two central concerns:

1. *Whether the creation and existence of the person was not for the principal purpose of obtaining benefits under the Canada-US treaty that would not otherwise be available.* Where this question is answered in the affirmative, the competent authority should determine that the person is entitled to treaty benefits. Obviously, the taxpayer requesting treaty benefits will need to present appropriate proof with respect to the principal purpose of its creation and existence in order to validate its claim. The competent authority's decision will surely depend upon the facts and circumstances of each case. The key issue to be resolved by the competent authority will most likely be whether or not the person claiming treaty benefits is somehow involved in a treaty-shopping scheme.
2. *Whether it would not be appropriate, having regard to the purpose of article XXIX A, to deny the benefits of the Canada-US treaty to that person.* Again, where the answer is affirmative, the competent authority should determine that the person is entitled to treaty benefits. This is a subjective determination and, again, will depend upon the facts and circumstances of each case. Since the purpose of the LOB article is to prevent treaty shopping, if the person claiming treaty benefits is a legitimate entity that simply did not meet any of the objective tests, treaty benefits should be granted.

Advance Determination

The technical explanation states that

> [f]or purposes of implementing paragraph 6, a taxpayer will be expected to present his case to the competent authority for an advance determination based on the facts. The taxpayer will not be required to wait until it has been determined that benefits are denied under one of the other provisions of the Article. It also is expected that, if

and when the competent authority determines that benefits are to be allowed, they will be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question, whichever is later (assuming that the taxpayer also qualifies under the relevant facts for the earlier period).[126]

Noted Differences

Under the provisions of paragraph 6, when duly requested, the US competent authority must make a determination, and where it is determined that benefits should be granted, the competent authority is required to grant those benefits. Although this would be the practice under all US tax treaties, only the Canada-US treaty is drafted in such a way as to oblige the competent authority to act.[127] It seems odd that, while in many aspects article XXIX A was drafted in more lenient terms than other limitation-on-benefits clauses, with respect to the competent authority, an obligation to act was specifically provided.

In addition, it appears that judicial review could be sought by a taxpayer who remains unsatisfied with the competent authority determination. According to the Treasury department, however, the threshold for such a review would be quite high, requiring a court to find that the competent authority had abused its discretion by acting in an arbitrary and capricious manner.[128]

The Senate Foreign Relations Committee does not favour any interpretation of this provision that would suggest that the competent authority may not have adequate authority to deny benefits. Nevertheless, the committee has recommended that in future treaty negotiations, any provision permitting the granting of treaty benefits by the competent authority should be drafted so as to clearly provide the competent authority with adequate discretion to deny benefits in appropriate circumstances as well.[129]

Practical Application of the LOB Tests

Takeover of a Corporation Resident in Canada

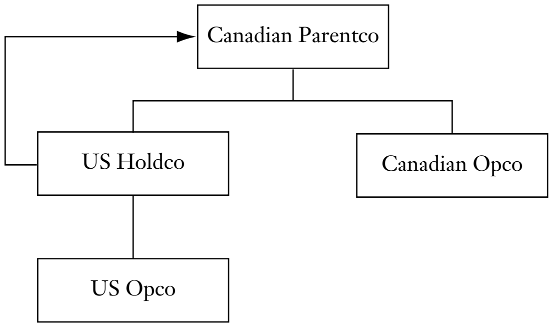
At the panel discussion referred to earlier in this essay, Carol A. Dunahoo, representing the US Treasury, was asked to illustrate the application of the various tests in the case of a takeover of a parent corporation resident in Canada.[130] I will focus my discussion on the Canadian parent corporation's entitlement to treaty benefits with respect to dividend and other payments received from a wholly owned US holding corporation. The corporate structure is shown in figure 3.

Status Before Takeover

Before the takeover of the Canadian parent corporation, the corporation would be entitled to treaty benefits to the extent that one of the following tests was met:

- *The publicly traded company test.* The principal class of shares of the parent corporation was substantially and regularly traded on a recognized stock exchange.

FIGURE 3



- *The subsidiary of a publicly traded company or trust test.* More than 50 percent of the vote and value of the subsidiary's shares was owned, directly or indirectly, by five or fewer companies or trusts qualifying under the publicly traded company or trust test (that is, each such company or trust was a qualifying person or a US resident or citizen).
- *The ownership and base erosion tests.* Fifty percent or more of the vote and value of the parent corporation's shares was not owned, directly or indirectly, by persons other than qualifying persons or US residents or citizens, and the base erosion test was satisfied.

Scenario 1

The first scenario to consider is the acquisition of the Canadian parent corporation by a US corporation. In such a case, the Canadian parent corporation would qualify for treaty benefits under the ownership test, provided that the base erosion test also was met. As a result of the takeover, the shares of the Canadian parent corporation would be owned directly by a qualifying person, namely, a resident of the United States.

Scenario 2

Now consider the case where the Canadian parent corporation is acquired by a foreign corporation that is resident in a country with which the United States has a comprehensive income tax treaty and that is entitled to benefits under the latter treaty. The Canadian parent corporation could still be entitled to treaty benefits under the derivative benefits test with respect to dividends, interest, and royalties to the extent that the following requirements of the ownership test were met:

- the foreign corporation, if it were a resident of Canada, would have qualified for benefits either as a qualifying person or under the active trade or business test; and

- the foreign corporation would be entitled to a rate of US withholding tax under the treaty between its country of residence and the United States that was at least as low as the rate applicable under the Canada-US treaty.

In addition to the above requirements, the base erosion test would need to be satisfied in order for the Canadian parent corporation to be entitled to treaty benefits following the takeover.

Scenario 3

Finally, consider the case where the Canadian parent corporation is acquired by a foreign corporation resident in a country with which the United States does not have a comprehensive income tax treaty. In such a case, the Canadian parent corporation would not be considered a qualifying person for the purposes of the treaty and would therefore not be entitled to treaty benefits. However, the Canadian parent corporation could still qualify for treaty benefits to the extent that the active trade or business test was satisfied. However, treaty benefits would be limited to income derived from the United States in connection with or incidental to that trade or business.

CONCLUSION

As discussed above, a person claiming treaty benefits under the provisions of the LOB article must not only be a resident of Canada but also meet additional criteria embodied in three separate classes of tests: the qualifying person test, the active trade or business test, and the derivative benefits test. In the event that none of these tests are satisfied, recourse may be had to the US competent authority for an ultimate determination based on the facts and circumstances of the particular case.

Unfortunately, although the LOB article was enacted in order to dissuade treaty shoppers, in some instances legitimate taxpayers with no treaty-shopping intentions may be denied treaty benefits from the United States as a result of not meeting the requirements of the specified tests. In particular, foreign controlled corporations, highly leveraged private corporations, and trusts with non-resident beneficiaries who would not be entitled to treaty benefits as a result of the LOB tests appear to have no alternative but to refer their request for treaty benefits to the US competent authority. These taxpayers will therefore be subjected to the inconvenience of having to present their request to the competent authority and waiting for a determination to be made. In such cases, taxpayers will incur professional fees in preparing their request.

Despite such inconvenience to specific taxpayers, the LOB article in the Canada-US treaty is, in certain respects, less strict than limitation-on-benefits clauses that have been incorporated in other US treaties, and than certain domestic US tax legislation. More specifically, the LOB article

- does not include a base erosion rule in the test relating to subsidiaries of publicly traded companies in order to limit potentially abusive structures;

- provides for the testing of aggregate vote and value in the ownership and base erosion tests without anti-abuse provisions prohibiting the issuance of shares that achieve a disproportionate allocation of rights in respect of the qualification of a company or trust as a qualifying person;
- extends qualification under the active business test to include a person related to the entity claiming treaty benefits where that person is conducting the active business; and
- includes the derivative benefits test, which extends certain benefits to a Canadian company that is wholly owned by third-country residents, even though the ultimate owners may not obtain the identical benefits under the treaty between their country of residence and the United States.

In the view of the Joint Committee on Taxation, the fact that the anti-treaty-shopping provisions in article XXIX A are looser than, or differ from, comparable provisions in other US tax treaties could create an unintended disincentive to third countries to enter into bilateral tax treaties with the United States, to the extent that those treaties would include more stringent limitation-on-benefits clauses.[131]

It remains to be seen how other countries will react to the United States' policy of inserting a limitation-on-benefits clause in all new tax treaties. It also remains to be seen how such clauses, and more particularly article XXIX A of the Canada-US treaty, will be interpreted by the courts and applied by the US tax authorities.

NOTES

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