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January 29, 2008

The Honorable Eric Solomon
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Linda E. Stiff
Acting Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Canadian-U.S. Treaty Protocol – Payments Through Hybrids

Dear Assistant Secretary Solomon and Acting Commissioner Stiff:

On September 21, 2007, the United States and Canada announced the signing of the Fifth Protocol ("Protocol") to the income tax convention between Canada and the United States (the "Treaty"). I am writing on behalf of the New York State Bar Association Tax Section to comment on certain aspects of the Protocol concerning the treatment of hybrid entities.[1]

The Protocol contains many welcome clarifications and additions to the current Treaty, including the zero withholding rate on interest, and we support ratification of the Protocol. The Protocol also extends treaty

[1] This letter was prepared by an ad hoc committee of the Tax Section consisting of Kimberly Blanchard, Peter Blessing, Peter Connors, Patrick Gallagher, David Hardy, David Miller, Yaron Reich, Richard Reinhold, Michael Schler, and Willard Taylor. David Hardy was the principal drafter.

benefits to U.S. residents deriving Canadian source income through a U.S. limited liability company ("LLC"). We do not intend our comments below to be an impediment to prompt ratification of the Protocol.

To effect the clarification of LLC look-through treatment, the Protocol adds a provision (as new Paragraph 6 of the residence Article (Article IV) of the Treaty) regarding income derived by residents through transparent entities that is consistent with Article 1, Paragraph 6 of the U.S. Model Treaty[2] as well as regulations under Section 894(c) of the Internal Revenue Code of 1986, as amended (hereinafter, the "Code").[3] The Protocol then adds a new Paragraph 7 to Article IV (herein referred to as the "Hybrid Clause"), limiting the extension of benefits for income derived through certain hybrid entities, i.e., entities treated as transparent by one jurisdiction but not by the other.

The new Hybrid Clause appears to deny treaty benefits to some situations having little or no apparent treaty-abuse potential from either a U.S. or a Canadian tax point of view. This letter describes some of these situations so that the Treasury can consider whether to exclude these (and perhaps other) non-abusive situations, either in a bilaterally agreed upon Technical Explanation of the Protocol or through a memorandum of understanding that is binding upon the U.S. and Canada pursuant to Article III, Paragraph 2 of the Treaty (permitting contracting states to mutually agree to a common definition).

I. Specific Treaty Language.

Article 2 of the Protocol amends existing Article IV (Residence) of the Treaty in several important ways.

Paragraph 6 of Article IV, as amended by the Protocol, treats income as derived by a resident where such income is derived through an entity that is fiscally transparent in the resident's country ("Transparent Entity Clause"), such as a fiscally transparent LLC (wherever located) in the case of a U.S. resident. Like Treasury Regulation §1.894-1(d)(1), amended Paragraph 6 allows treaty benefits to a recipient of income through a transparent entity provided the recipient is subject to tax in the resident country. It provides:

> "An amount of income, profit or gain shall be considered to be derived by a person who is a resident of a Contracting State where: (a) the person is considered under the taxation law of that State **[the Residence State]** to have derived the amount through an entity (other than an entity that is a resident of the other Contracting State **[the Source State]**); and (b) by reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State **[the Residence State]**, the treatment of the

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2 United States Model Income Tax Convention (November 15, 2006) (hereinafter the "2006 Model Treaty").

3 See Treas. Reg. §1.894-1(d). Unless otherwise indicated, all "Section" references are to the Code.

amount under the taxation law of that **[Residence]** State is the same as its treatment would be if that amount had been derived directly by that person."

New Paragraph 7 of Article IV, the Hybrid Clause, limits the scope of Paragraph 6 by providing:

"An amount of income, profit or gain shall be considered not to be paid to or derived by a person who is a resident of a Contracting State where:

(a) The person is considered under the taxation laws of the other Contracting State **[Source State]** to have derived the amount through an entity that is not a resident of the first-mentioned state **[Residence State]** but by reason of the entity not being treated as fiscally transparent under the laws of that state **[Residence State]**, the treatment of the amount under the taxation law of that state **[Residence State]** is not the same as its treatment would be if that amount had been derived directly by that person; or

(b) The person is considered under the taxation laws of the other Contracting State **[Source State]** to have received the amount from an entity that is a resident of that other State **[Source State]**, but by reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State **[Residence State]**, the treatment of the amount under the taxation law of that State **[Residence State]** is not the same as its treatment would be if the entity were not treated as fiscally transparent under the laws of that State **[Residence State]**."

Clause (a) refers to a Canadian investor in a hybrid entity (transparent for the U.S., non-transparent for Canada), such as the U.S. LLCs that were the original target of Section 894(c), or a U.S. investor in the Canadian analog, i.e., an entity transparent for Canada but not transparent for the U.S. Clause (b) refers to a Canadian investor in a domestic reverse hybrid (non-transparent for the U.S. and transparent for Canada), which was covered by regulations.[4] Clause (b) also applies to a U.S. investor in an analogous Canadian entity that is non-transparent for Canada but transparent for the U.S.

The effective date of the new Paragraph 7 (the Hybrid Clause) is deferred two years from the general effective date of the Protocol.[5]

II. Non-Abusive Situations.

The Hybrid Clause of the Protocol appears to deny treaty benefits to items paid by certain hybrid entities. Most readers assume this denial of benefits is due to the potential of hybrids to

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4 See Treas. Reg. §1.894-1(d) (2).

5 Protocol, Article 27, paragraph 3(b).

facilitate either the double dipping of tax benefits or the double non-taxation of income, which are regarded as unintended and abusive benefits.[6] Unlike Treasury Regulation §1.894-1(d)(2), which generally permits treaty benefits to items derived from a domestic reverse hybrid provided the items are derived by residents of the other country, the Hybrid Clause denies treaty benefits to items derived from a reverse hybrid. In this respect, the Hybrid Clause imposes a more onerous treatment of reverse hybrids subject to the U.S.-Canada Treaty, than the regulations under Section 894 impose for U.S. tax treaties generally. We regard this action as a permissible use of the U.S. tax treaty authority.

However, a significant number of business transactions operate through hybrid vehicles without any tax abusive motivation or effect. For example, where hybrid structures do not involve borrowings, the opportunity to deduct interest simultaneously in two different jurisdictions is not present. We question whether such non-abusive transactions were the intended target of the hybrid provision. Set out below is a list of several reverse hybrid structures apparently within the ambit of Paragraph 7(b) of the Hybrid Clause that we believe are not abusive, i.e., they are not used to create double deductions, deductions without income inclusions, or double non-inclusions.

(a) U.S. corporate investor into Canada: NSULC in lieu of branch investment. A U.S. corporation ("USCo") investing into Canada might desire to invest through a branch so that its U.S. taxable income has the same active character in the United States as if earned directly. Branch taxation is also useful because the expenses incurred by the branch are treated as expenses of the U.S. consolidated group, and the gross income of the branch is foreign source gross income without reduction for foreign expense. This improves the U.S. foreign tax credit limitation calculations in a manner approved in the partnership anti-abuse regulations.[7]

USCo, however, may find branch taxation in Canada unattractive for several reasons. Branch operations would require that USCo file Canadian tax returns and allocate its items to the branch in accordance with the Treaty rules for attribution of profits. Moreover, operating through a natural branch would subject USCo to Canadian branch profits tax, which could in turn subject USCo to deemed dividends on reductions in branch operating capital when cash is not actually removed from the branch.

To alleviate these issues, USCo might choose to establish its Canadian activities in a wholly owned Nova Scotia (or Alberta) unlimited liability company ("NSULC"), which defaults into disregarded treatment for U.S. income tax

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6 See e.g., Treas. Reg. §1.894-1(d)(2) and NYSBA Tax Section Report No. 1004 on the Section 894 Regulations (Jan. 14, 2002), http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1004report.pdf, *reprinted in* Tax Notes Today (Jan. 15, 2002).

7 See Treas. Reg. §1.701-2(d) Example 3.

purposes.[8] The NSULC would be taxed as a corporation in Canada, and therefore USCo would not be subject to Canadian branch profits tax or be required to file a Canadian tax return.

(b) U.S. individual investor into Canada: NSULC for Section 901 credit. U.S. individuals investing in a Canadian business might similarly prefer to invest through an NSULC. The NSULC would incur corporate income tax in Canada. The U.S. individuals would not be required to file Canadian income tax returns. Importantly, the NSULC's distributions would not bring up Section 902 foreign tax credits to the investors (which individuals are not generally able to utilize), but would bring up Section 901 foreign tax credits.

(c) U.S. corporate investor into Canada: NSULC for basis bump. Often a U.S. corporation ("USCo") acquiring the shares of a Canadian corporation ("Canco") seeks to increase the Canadian tax basis in the acquired assets to reflect the stock purchase price under Canadian rules ("basis bump"). These transactions are particularly useful when the Canco has U.S. subsidiaries that USCo would like to extract from Canadian ownership. The formation of a Canadian acquisition company to acquire Canco, followed by an amalgamation, will generally cause the assets of the amalgamated target company to reflect the purchase price for target's stock for Canadian tax purposes, permitting the extraction of the target's U.S. subsidiary without further Canadian tax consequences.

If the Canadian acquisition company is an NSULC, then even if the acquisition is not a qualified stock purchase for Section 338 purposes, Canco's U.S. subsidiary stock basis might also be stepped up for U.S. tax purposes upon the amalgamation under Sections 331 and 334(a). In this instance, the use of an NSULC facilitates efficient tax planning without any double dipping of the benefits.

(d) U.S. investor into Canadian partnership: NSULC to avoid non-Canadian partnership. Under Canadian tax rules, a Canadian partnership having only Canadians as partners is treated as a pure pass-through, and Canadian source income can flow through it without withholding. If non-Canadian partners are present, the partnership is not considered a Canadian partnership for Canadian tax purposes and withholding may be required. When U.S. investors are admitted into such a partnership structure, their Canadian partners frequently require that they invest indirectly through another Canadian entity to preserve the partnership's "Canadian" status. The U.S. investors will often desire to avoid the U.S. tax issues of investing through a foreign corporation (e.g., CFC, PFIC). These U.S. investors may utilize an NSULC, simply to avoid unnecessary U.S. tax issues resulting from their desire to accommodate the requirements of their Canadian investment partners.

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8 Treas. Reg. §301.7701-3(b).

(e) Canadian investor into U.S.: domestic reverse hybrid blocker. Canadians (including Canadian tax-exempt organizations) often invest into the United States utilizing a U.S. partnership that checks the box to be treated as a corporation for U.S. tax purposes. A common example would be where a group of Canadians invest through a partnership to acquire U.S. real property investments. Because the real property gains would be subject to FIRPTA under Section 897, the Canadian investors would be subject to (i) U.S. taxation on their gains attributable to the disposition of U.S. real property interests, and (ii) for a Canadian corporate investor, U.S. branch profits tax. To avoid U.S. return filings and U.S. branch profits tax exposure, the investors will frequently form the partnership under U.S. law and check the box to treat the U.S. partnership as a domestic corporation. Canadian investors might not wish to invest through a normal U.S. corporation for Canadian tax and non-tax reasons. Thereafter, the U.S. partnership will pay U.S. corporate income tax on gains from selling the real property investments, and after-tax proceeds will be distributed to Canadian investors subject to appropriate withholding tax, if any.

(f) Canadian investor into U.S.: domestic reverse hybrid to clarify U.S. tax treatment. Occasionally, a Canadian financial institution or pension fund investing in the U.S. markets may seek to have a particular line of its investment activities, e.g., hedging or derivatives trading, treated as a separate line of business for U.S. tax purposes (e.g., for purposes of Section 475 or 892). These activities can be so isolated by conducting them through a U.S. partnership that checks the box to be treated as a corporation for U.S. tax purposes.

(g) Canadian investor into U.S.: domestic reverse hybrid for local tax planning. Canadians have also used reverse hybrid structures to facilitate local tax planning. For example, a Canadian company with a U.S. business may operate its U.S. business through a U.S. partnership so that the Canadian parent company can allocate portions of its capital to the U.S. permanent establishment, thereby reducing provincial capital tax. The U.S. partnership would check the box to be treated as the parent corporation of a U.S. consolidated group. Assume no double dip benefit are obtained in the structure.

In each of the foregoing examples, a hybrid entity is involved. The entity is resident in the source country and fully subject to taxation in the source country. That entity, while treated as a corporation for the source country's purposes, is fiscally transparent from the perspective of the residence country. Under the literal language of Paragraph 7(b) of the Hybrid Clause, distributions from such an entity would be excluded from treaty benefits and would be subjected to maximum source country withholding tax, notwithstanding that a different rule would apply under the Section 894(c) regulations in the absence of Paragraph 7(b). As a result, distributions of operating income are subject to full source country income tax when the income is earned plus full source-country withholding tax upon distribution, potentially pushing the overall effective rate of tax in the source state beyond 50%. This result appears inappropriate and unintended, inasmuch as the relevant entities have paid full tax in the source jurisdiction and are distributing their after-tax profits to investors who are subject to tax in their home country.

III. Same Treatment.

It would seem that these common structures described above may not have been the intended subjects of the Hybrid Clause of the Protocol. Potentially, a bilaterally effective Technical Explanation (or a mutually agreed upon memorandum of understanding) could interpret the Hybrid Clause in a manner that clarifies that these common and non-abusive situations are not within its scope.

The interpretation of the Protocol to exclude these unobjectionable situations presents challenges. As drafted, Paragraph 7(b) of the Hybrid Clause provides that payments through a hybrid entity will not be treated as derived by a resident, if "the treatment of the amount under the taxation law of the [residence] State is not the same as its treatment would be if the entity were not treated as fiscally transparent under the laws of that state." If the "same treatment" is thought of in a manner consistent with U.S. principles of fiscal transparency under Section 894, one might think that this sentence requires identity of timing, source, and character.

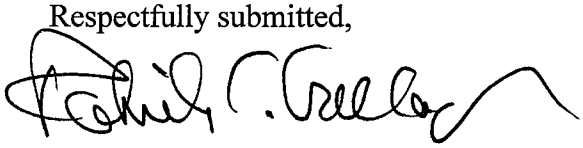
Paragraph 6 applies the Section 894 test of the "same treatment." Paragraph 6 asks whether receipt through a transparent entity is the same as direct receipt. In that context, the traditional meaning of same treatment, i.e., same timing, source and character, can be applied readily. If identity of timing, source and character exists, then the entity would be treated as fully transparent and the benefit of Article IV(6) would be available. But in the context of Paragraph 7, the identity of timing, source and character seems incapable of being satisfied. In general, it is not possible for a fiscally non-transparent entity to pass through income in a manner which is identical in timing, source or character to a fiscally transparent entity. Accordingly, one might conclude that the identity of timing, source and character is not the appropriate standard by which to judge the sameness of the treatment for payments through hybrids.

As an alternative interpretation, the drafters of a bilateral Technical Explanation might conclude that, for purposes of Paragraph 7(b), the treatment shall be considered "the same" if the timing, character and source are not altered in an abusive manner. For this purpose, items will be treated as having substantially the same treatment provided that the items passing through the hybrid entity do not, as a result of passing through the hybrid, result in (i) a double deduction or a deduction without associated income inclusion, or (ii) double non-taxation of an income item. Language of this type could resemble the U.K. anti-arbitrage legislation which was also designed to address hybrid entities generating unanticipated tax benefits.

While such an interpretation has weaknesses, it may be felt to flow logically from inability of a hybrid to satisfy the more conventional notions of same treatment. If the Technical Explanation interpreted the "same treatment" language of Paragraph 7, in the manner described above, none of the examples described above would be affected by Paragraph 7(b). In each of the enumerated examples above, there is no double deduction and no deduction without associated income inclusion. As a result, distributions from each such hybrid entity should be permitted to enjoy reduced dividend withholding rates under the Treaty when such amounts were distributed to their Canadian or U.S. owners. And under such interpretation, Paragraph 7(a) would still operate to deny the treaty benefits to domestic hybrids to the extent that they permit a U.S. deduction without associated income inclusion.

Whether by interpreting "same treatment" or by other means, consideration should be given to excluding non-abusive transactions, such as those described above, from application of the Hybrid Clause of the Protocol. We understand that any approach to exclude non-abusive transactions from the scope of the Hybrid Clause would have to be agreed upon by the United States and Canada to be effective. We assume that a bilateral Technical Explanation or a Memorandum of Understanding would satisfy this requirement.

Respectfully submitted,



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