



The USD School of Law - Procopio International Tax Institute
2010 International Update: U.S.-Mexico Cross-Border Tax Issues



U.S.-Canada Income Tax Treaty – Fifth Protocol (LLCs, Hybrid Entities) and Other Treaty Developments

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LLCs: Pre-5th Protocol

- Corporations from Canadian POV
 - *Boliden Westmin* case
- CRA's position on LLCs as not being resident in U.S.
- Contrast with S Corporations



US – Canada – 5th Protocol

- Entered into force in late 2008
- Effect of provisions generally in 2009
- Some provisions effective as of 1/1/2010 (e.g., PE services rule, IV(7) anti-hybrid rule)
- Special relationship with Canada reflected in new protocol



US – Canada – 5th Protocol – Highlights

- Treatment of dual resident companies 4(3)
- Fiscally transparent entities -4(6) and (7)
- PE provisions related to services 5(9)
- Updated pension provisions -18(8)-(10)
- Reduced withholding on interest -11
- Arbitration provisions 26(6) – (7)
- LOB provisions made bilateral -29A



US – Canada – 5th Protocol – Hybrid Entities

- US LLC issue – Before protocol, no benefits for US investors deriving income in Canada through a US LLC
 - Canada views US LLC as a company - but not resident in US
 - Lack of benefits resulted in inefficient structures or reduced investment
- Canada interested in addressing arbitrage through use of “tower” structure



Stakes to US – Canada Taxation

- US or Canadian withholding tax
 - Ex. Dividends – US (30%) – Canada (25%)
 - Treaty - 5% or 15%
- US or Canadian branch tax
 - US (30%) - Canada (25%)
 - Treaty – 5%
- PE protection



Mexico- Transparent entities

- Canadian LLCs / US LLCs
 - Recognized as legal entities for Mexican Tax purposes
 - Payments made are considered received by the entity
 - Income is attributable to the entity not the members. No recognition of tax transparency



Mexico- Transparent entities

- Definition of Transparent entities contained in the Income Tax Law, mainly for antideferal rules (CFC).

“Entities or legal figures not considered as income taxpayers in the country of incorporation or in the country where they have their place of effective management and the income is attributable to its members.”



Mexico-Canada LLC

- No recognition of DTC benefits:
 - Payments made to a Canadian LLC are fully sourced in Mexico.
 - 40% tax rate applicable to payments made to an LLC which is a related party.
 - Presumption of non compliance with arm's length principle:
 - Denial of the deduction for the Mexican payor.

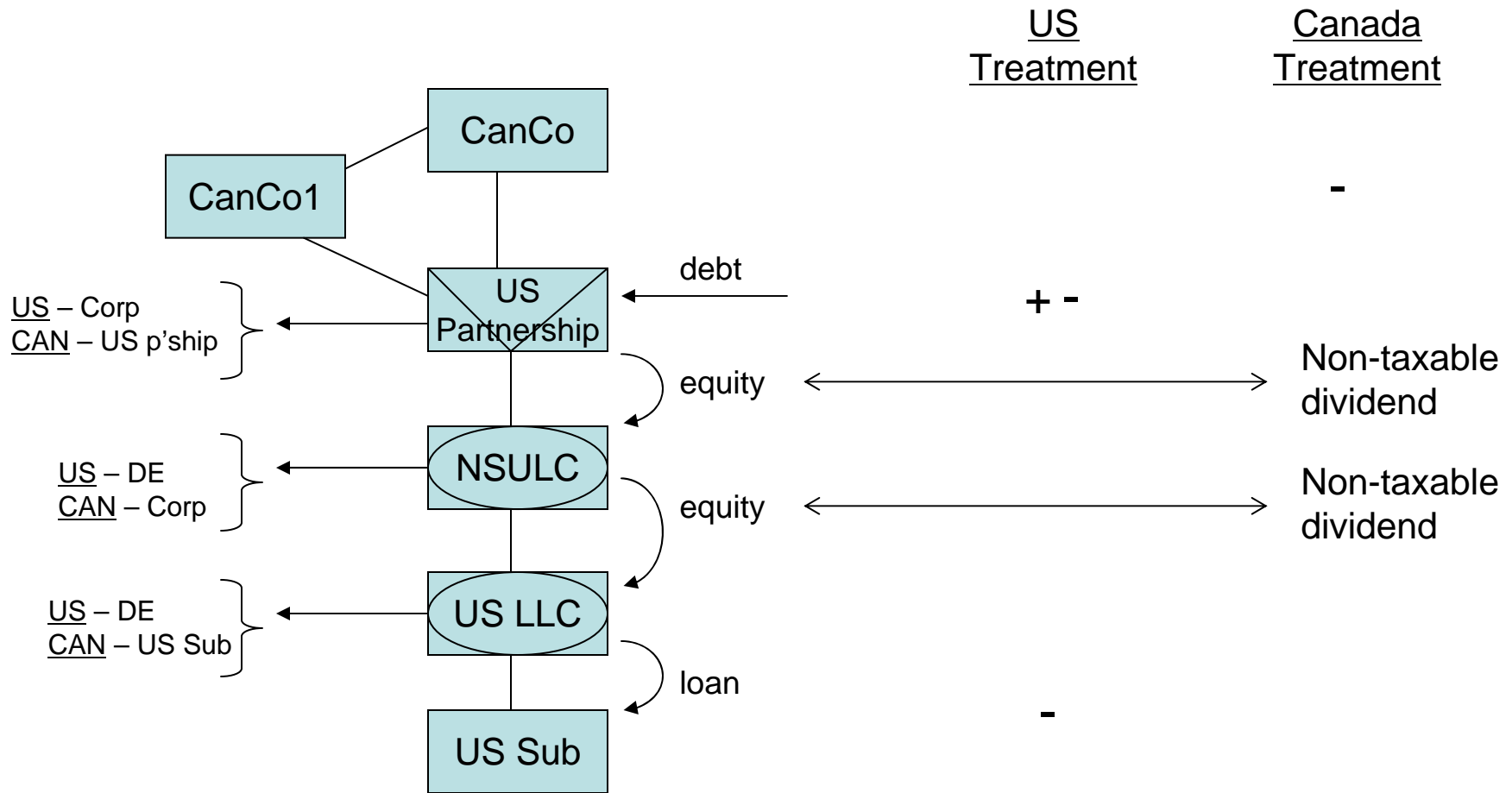


Canadian Concerns – Background

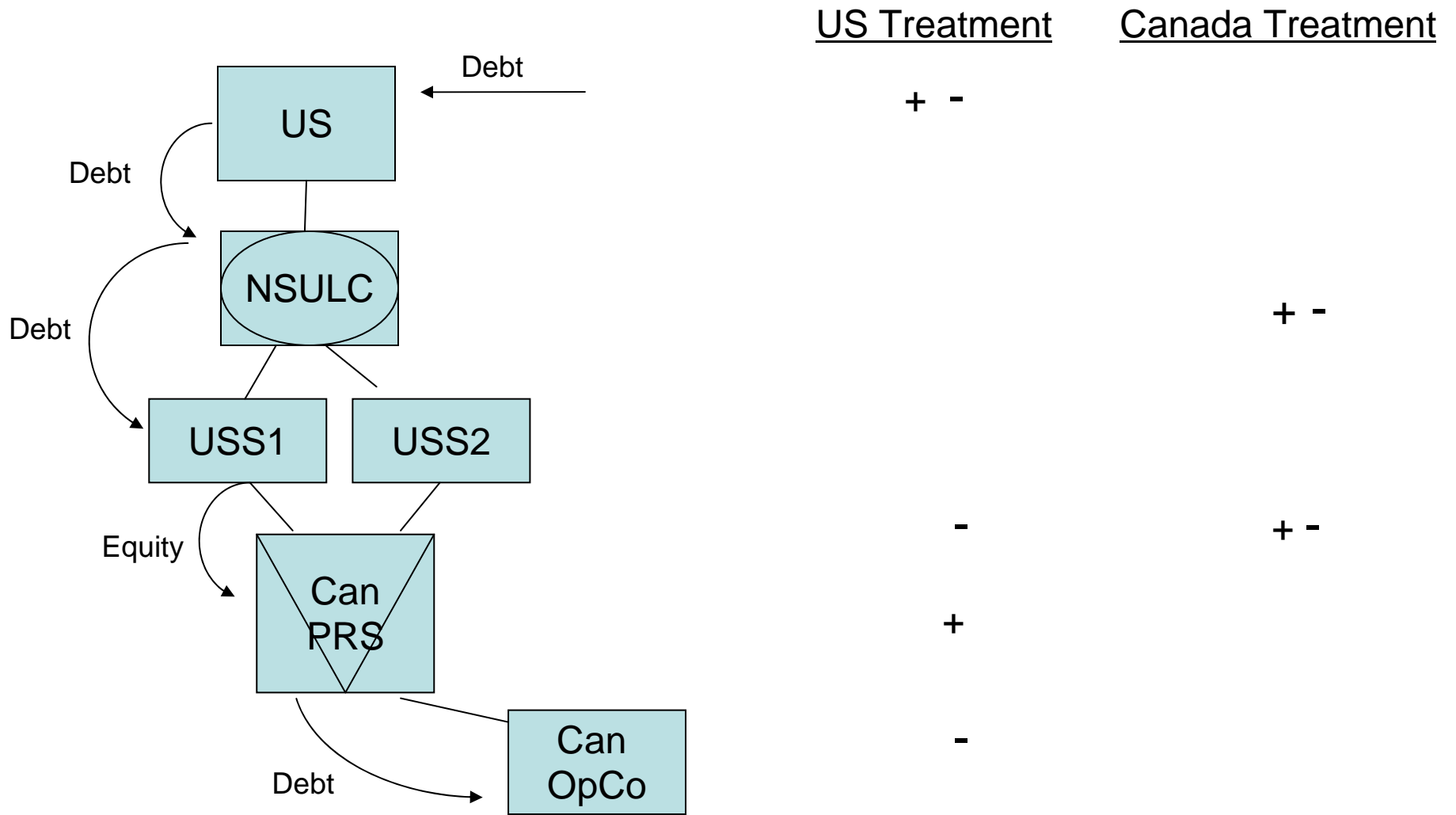
- “Tower” structure financing to achieve effective double dip in Canada and US
- Arbitrage of US CTB rules and Canada’s “exempt status” treatment
 - Cross-border payment seen in only one country
 - Exempt treatment so dividends received without Canadian tax



“Tower” Structure



“Tower” Structure



Effects of “Tower” Structure

- Lowers the cost of investment outside Canada as compared to investment in Canada
 - Incentive for Canada business to acquire/locate new operations (i.e., jobs) outside Canada
- Subsidizes expansion of groups from bases in Canada
- Arguably desirable for Canadian corps



US – Canada – 5th Protocol – Hybrid Entities

- New 4(6) generally addresses US LLC issue by broadly referencing fiscally transparent entity (FTE) from residence state perspective
- Impact on income and gains, PE determinations, branch tax
- Related change in 10(2)(a) – permits ownership through FTE to meet
 - 10% ownership threshold for dividends
 - LOB Ownership/base erosion test



Fiscally Transparent Entities

- No definition of FTE in treaty
- TE references US 894 regulations for principles
 - No comparable Canadian rules but Canada agrees to apply principles
- Examples of US FTEs include partnerships, LLCs, grantor trusts, S-corporations
- Key is timing, source and character of income
- CRA has said that source factor is not vital



Paragraph 6 – General Rule

Considered derived by resident of residence state if

- (1) Amount is derived by person through an entity that is an FTE from residence state perspective
- (2) FTE is not a resident of the source state

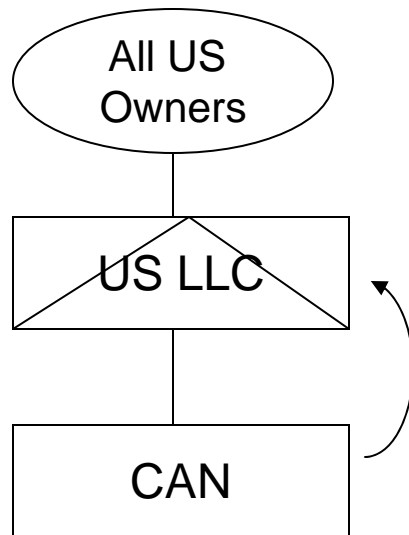
And

- (3) Because the entity is an FTE in residence state the treatment of the amount under the residence state is the same as its treatment if the amount was derived directly



Paragraph 6 – Canadian Perspective

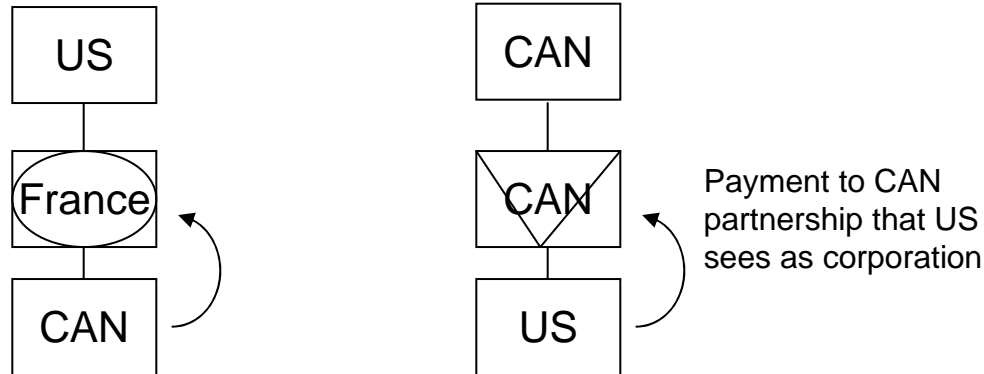
Application using Canadian principles



- US LLC not a resident of the US
- But for ¶6 – no benefits
- Per ¶6 Canada will suppress taxation – grant benefits to US LLC based on US ownership
- Canada still sees US LLC – no change in status of US LLCs under Canadian law
 - No Canadian tax returns by US owners of US LLC
 - US LLC files a Canadian tax return – claims benefits for owners
 - PE determination made by presence and activities of US LLC only (not owners acting in their own right)
 - US would make PE determination by looking at entity and its owners



Paragraph 6 – Derived by a Resident



Considered derived by resident of residence state if

(1) Amount is derived by person through an entity that is not a resident of the source state

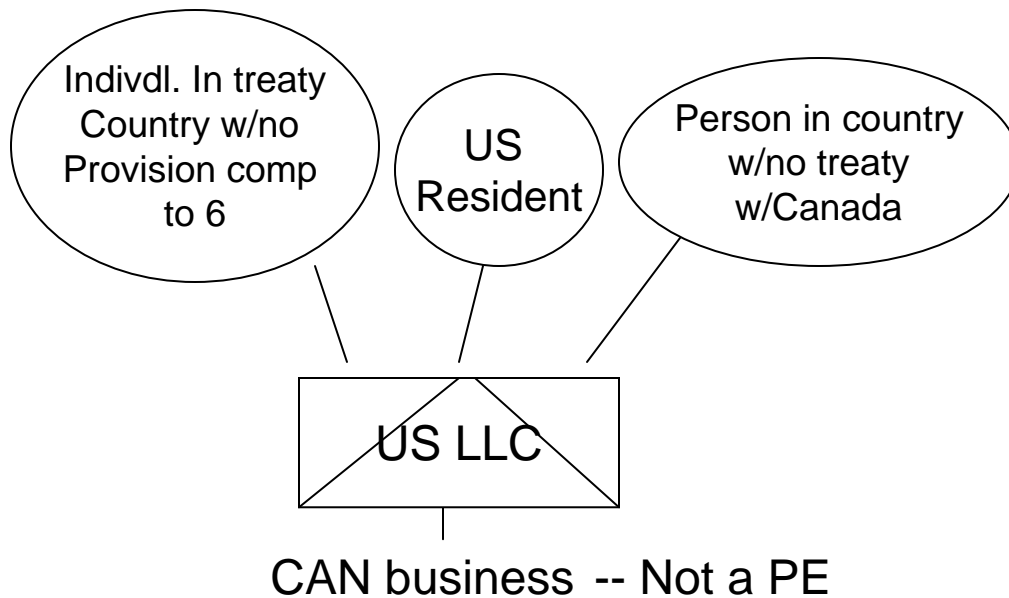
And

(2) Because the entity is an FTE in residence state the treatment of the amount under residence state is the same as its treatment if the amount was derived directly

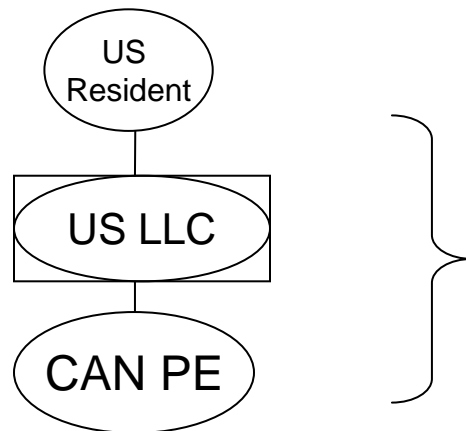
* ¶6 applies in respect of dividends, interest and royalties and gains on other income



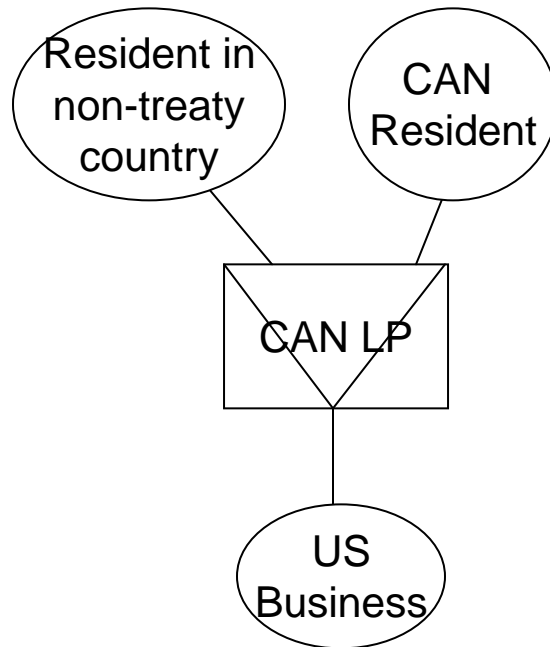
Canadian Application of PE Provisions



- CAN determines PE from LLC's perspective
- If US resident meets LOB – US resident's portion of profits is not taxable in Canada
- Seen as derived by US shareholder
- Balance is taxable in Canada



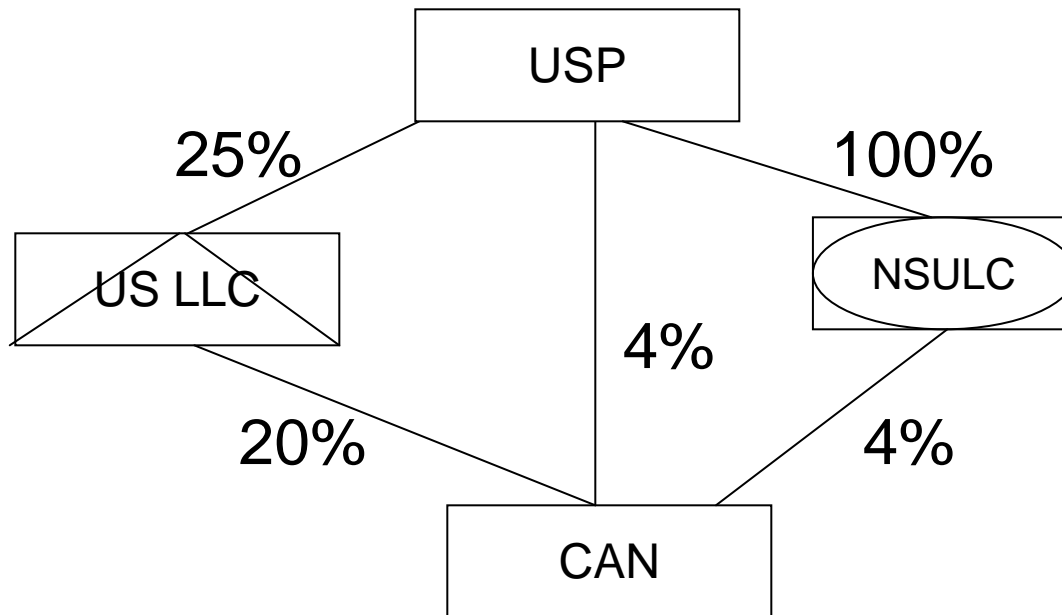
US Application of PE Provisions (cont)



- US looks at entity and its owners to determine PE
- If there is a PE of CAN LP – CAN LP is transparent in Canada – activities may be attributed to its partners
- If there is no PE – CAN resident can claim benefit of PE article



Article 10(2) – Attribution of Ownership



- 10(2) allows attribution of ownership through fiscally transparent entities for dividend purposes
- Allows attribution through US LLC
- No attribution through entities that are resident in the source state – i.e., through NSULC
- Attribution also permitted for ownership/base erosion LOB qualification



Open Issues

- Proving up US ownership
- Treatment of non-LLC entities (e.g., discretionary vs. mandatory distribution trusts)
- Treatment of payments entirely disregarded from US perspective (e.g., ULC dividend to LLC)

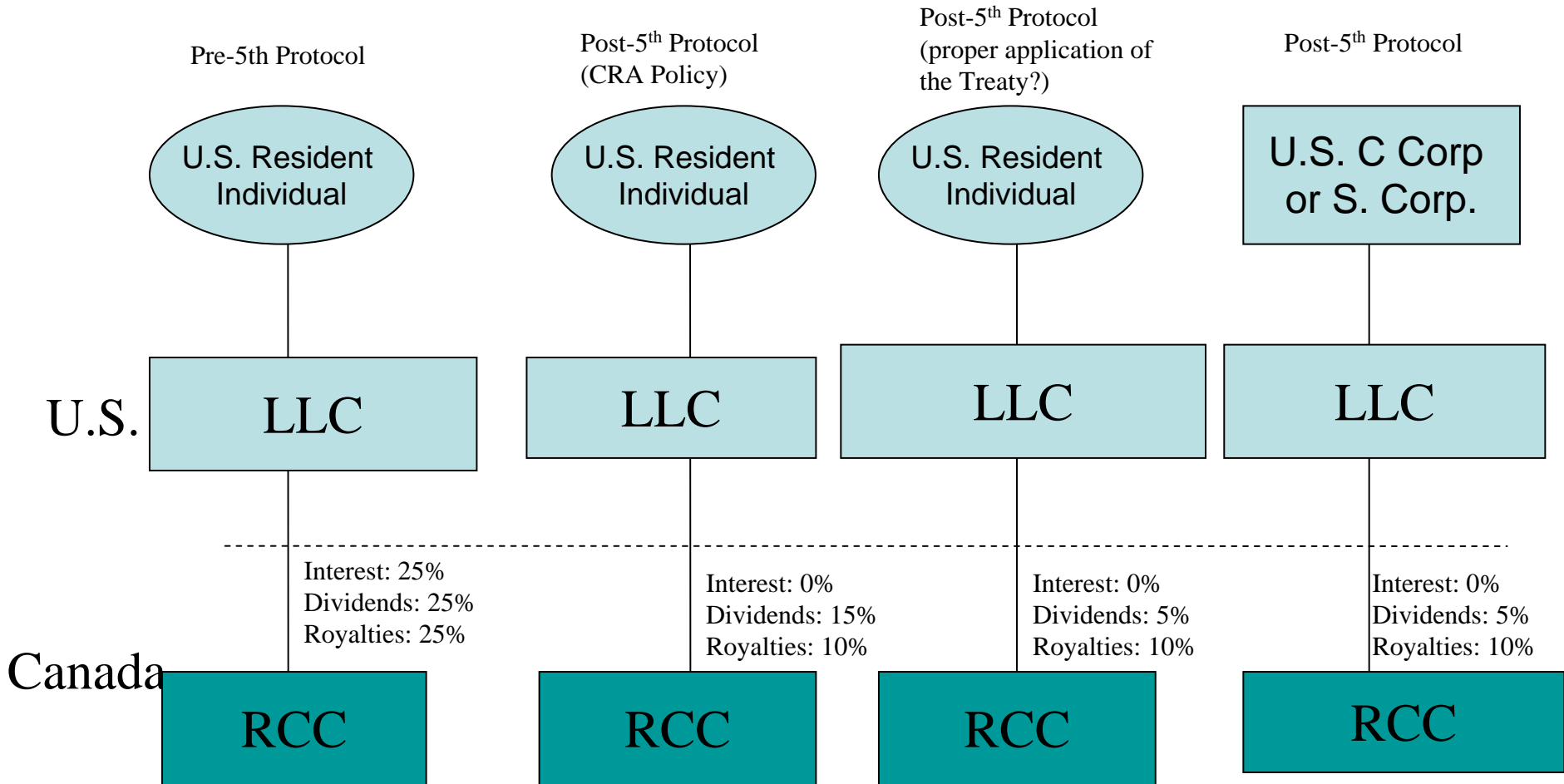


LLCs: Post-5th Protocol

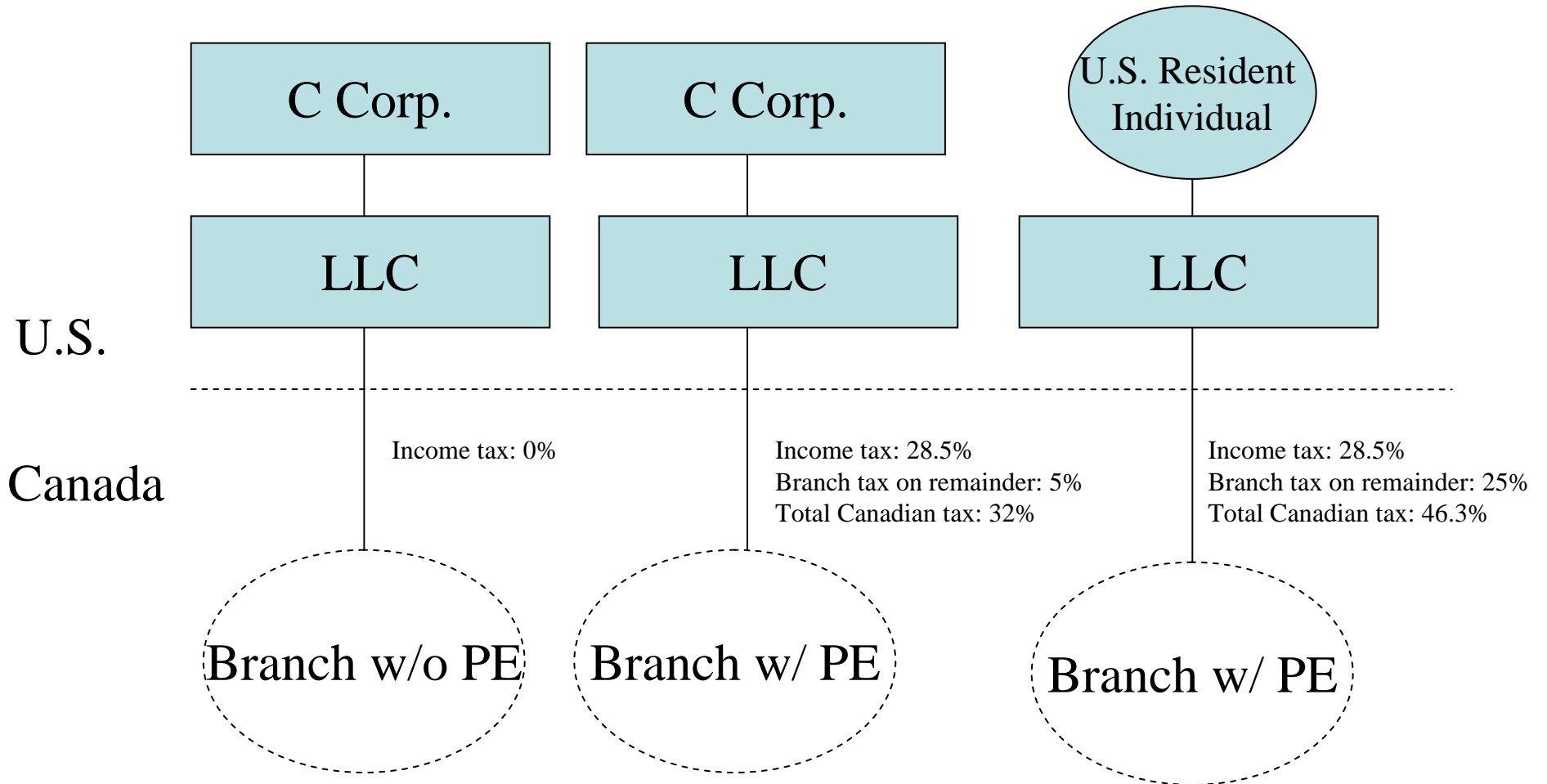
- *TD Securities (USA) LLC* Tax Court of Canada
 - (some) LLCs were resident pre-5th Protocol
 - CRA did not appeal
 - CRA not applying to post-5th Protocol period
- CRA rulings and interpretations



LLCS



LLCS cont'd



S Corporations

- Recap Pre-5th Protocol treatment
- 5th Protocol – Article IV(6):
 6. 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 to have derived the amount through an entity (other than an entity that is a resident of the other Contracting State); and
 - (b) By reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is the same as its treatment would be if that amount had been derived directly by that person.



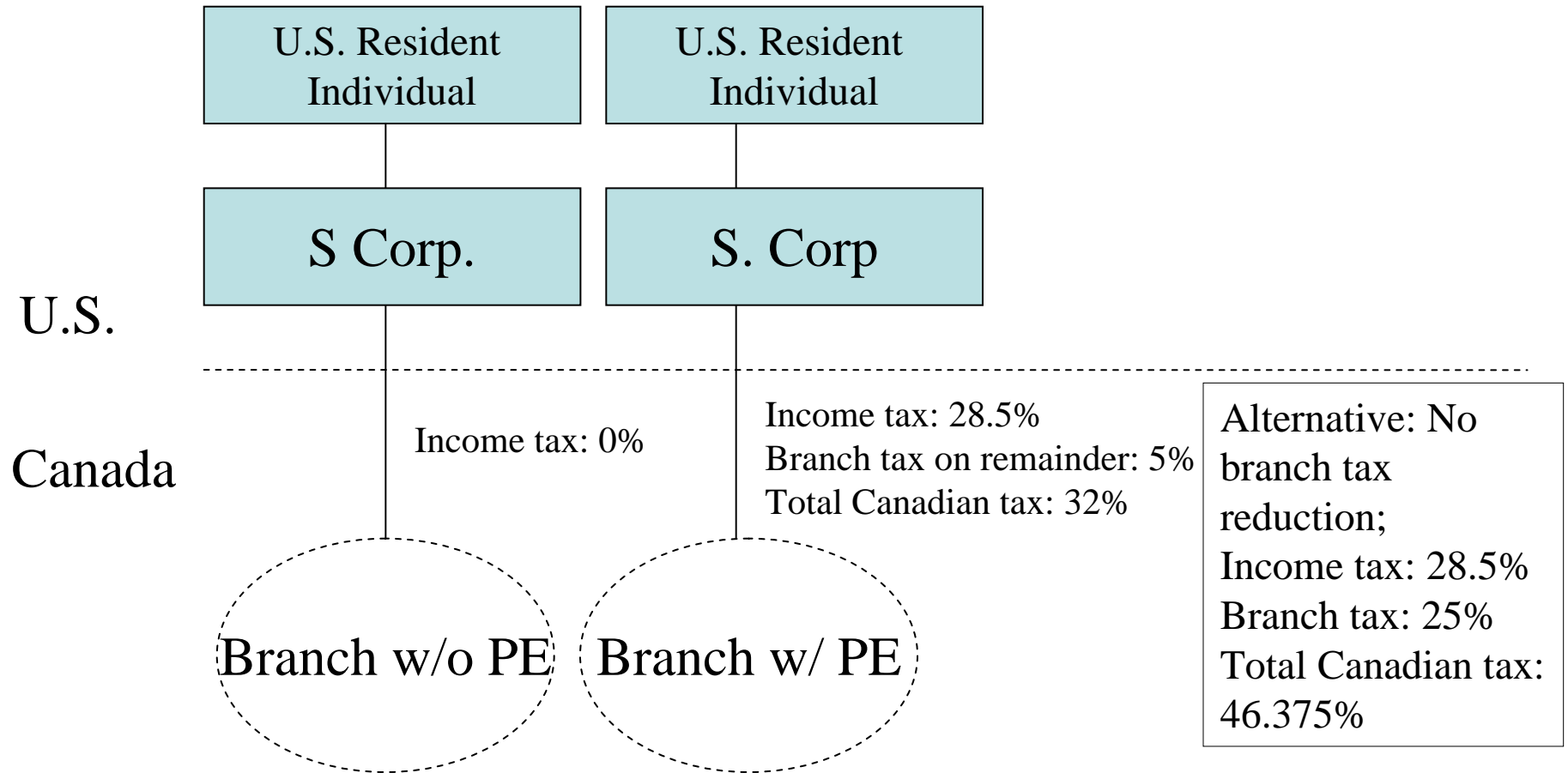
S Corporations

- CRA position on residency for treaty purposes post-5th Protocol
- Continuing distinction between LLCs and S Corps
 - Even less tenable now
 - *TD Securities*

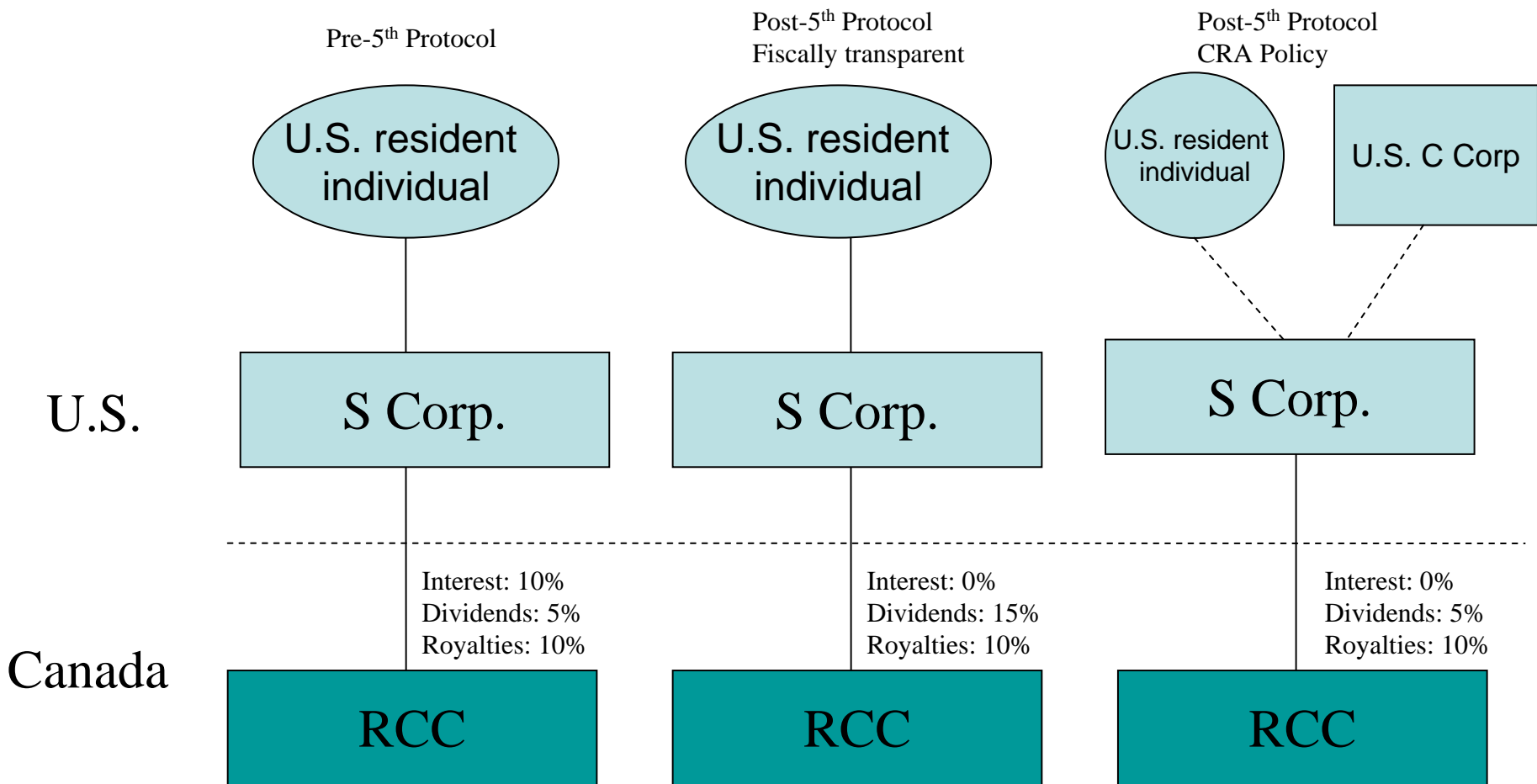


S corps

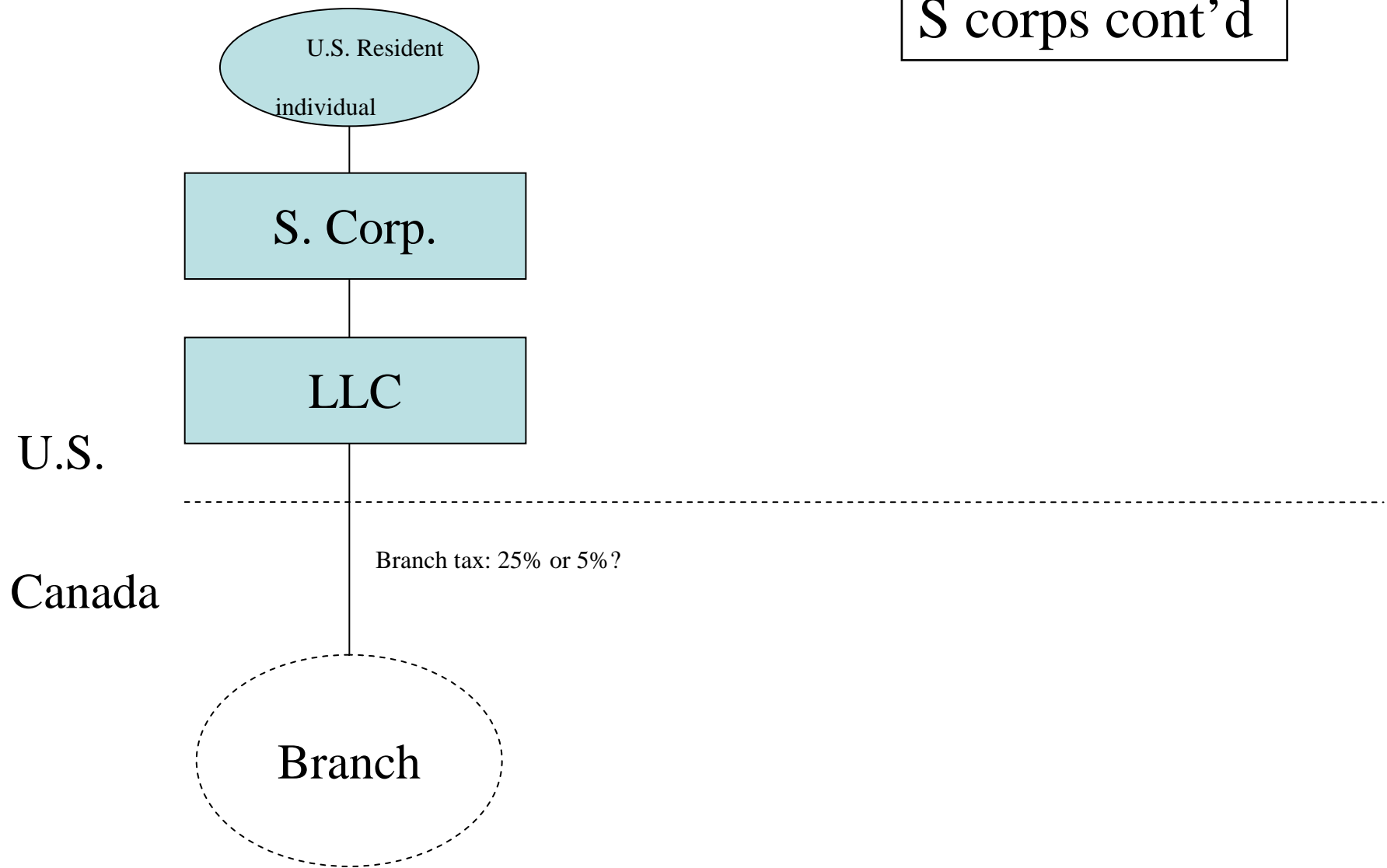
Current CRA Policy on S Corporation



S corps cont'd



S corps cont'd



Overview Paragraph 7

- Two rules provided in new paragraph 7 - designed primarily to address tower structure and granting of benefits where no corresponding US income inclusion
- Generally prevents benefits where income is not derived through an FTE from residence perspective
- Generally prevents benefits where no income pickup seen in residence state



Paragraph 7(a) – General Rule

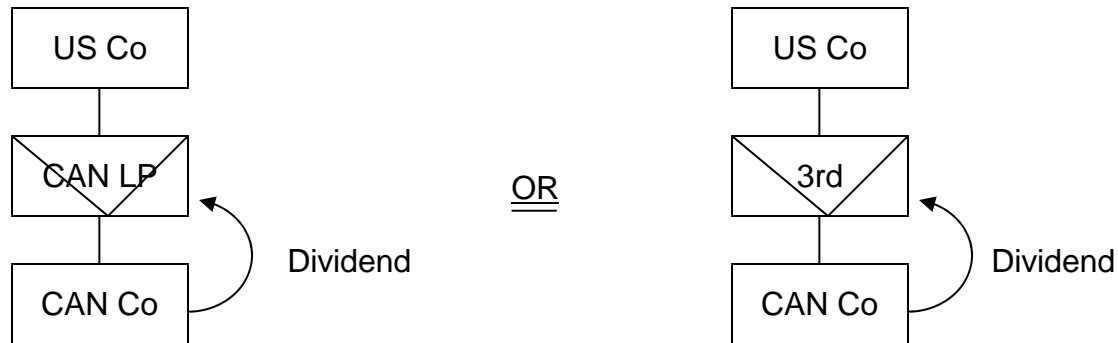
Amount not paid to or derived by resident if

- Source state views person as deriving the amount through an FTE;
- Resident state sees payment to non-FTE entity that is not a resident of the residence state; and
- Because the entity is not transparent in residence state the tax treatment in the residence state is not the same as if derived directly



Paragraph 7(a) – Outbound

7(a) Not Fiscally Transparent in Residence State



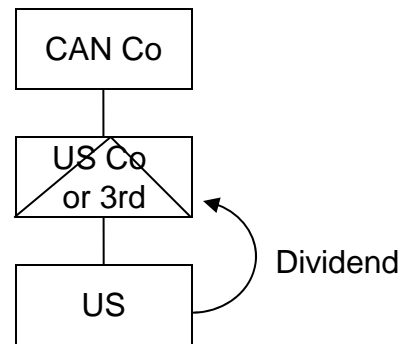
- CAN sees payment to US Co (through CAN LP or 3rd)
- CAN LP (or 3rd) is not a resident of US
- US sees payment to CAN LP (or 3rd) – not fiscally transparent

Because US sees payment to CAN LP (or 3rd) treatment under US law is not the same as if US Co derived directly



Paragraph 7(a) - Inbound

7(a) Not Fiscally Transparent in Residence State



- US sees CAN Co deriving amount through US Co (or 3rd)
- US or 3rd not resident in Canada
- Canada sees payment to US Co (3rd) – a non-transparent entity
- Tax treatment to Can Co not the same as if CAN had derived the amount directly



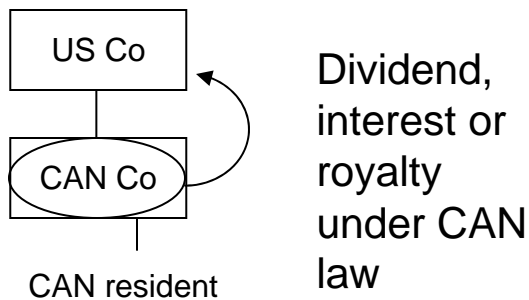
Paragraph 7(b) – General Rule

Amount not paid to or derived by resident if

- Source state views person as receiving amount from resident of source state
- Residence state sees payor as an FTE
- By reason of being an FTE in the residence state, the amount received is not treated the same in residence state as if payor was not an FTE

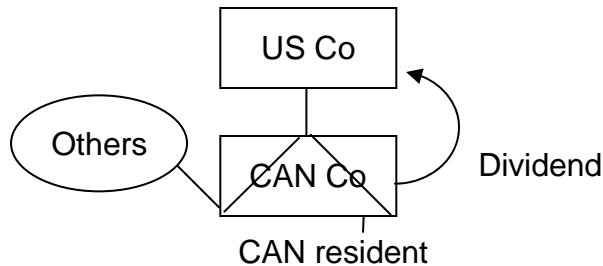


Paragraph 7(b) - Outbound



Not paid to or derived by US Co

- (1) CAN sees payment by CAN Co (CAN resident)
- (2) US sees CAN Co as fiscally transparent
- (3) Payment not treated the same if not disregarded

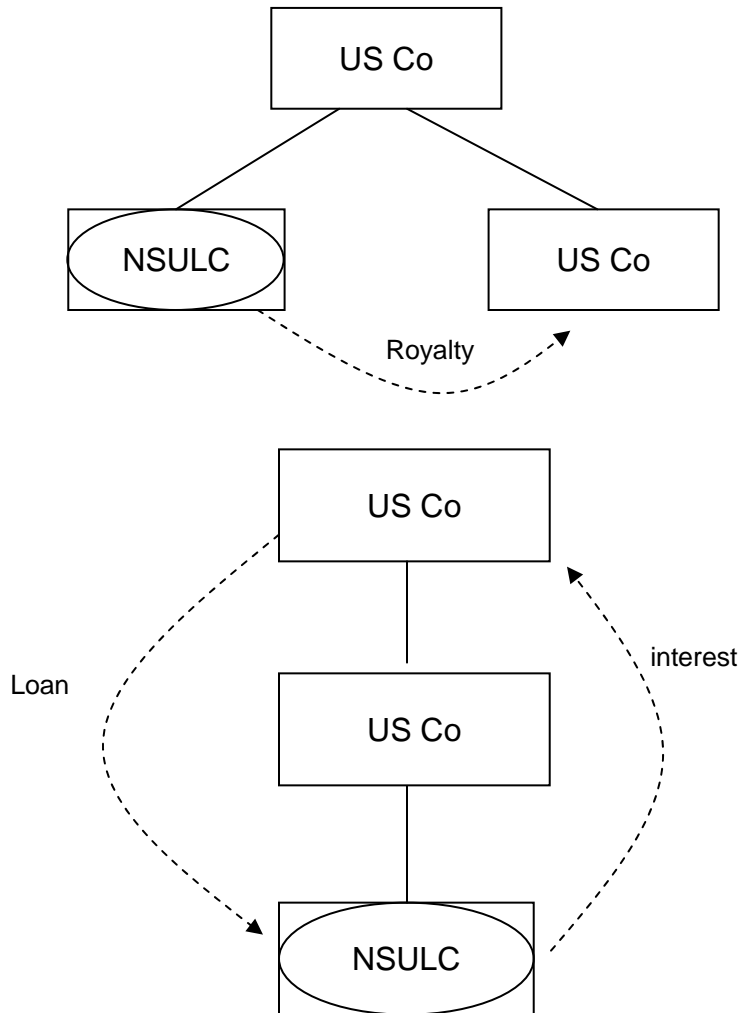


- (1) CAN sees dividend by CAN Co
- (2) US sees CAN Co as partnership
- (3) Partnership distribution vs. dividend (not same – not derived by)

** Result different where payment by CAN Co is interest or royalty payment



Paragraph 7(b) – Outbound



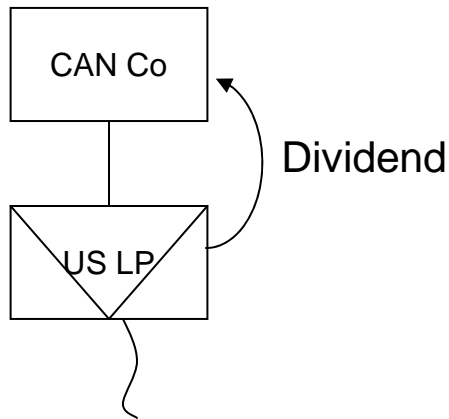
Paragraph 7(b) – Test

- Source state sees payment by resident
- Resident state sees payment by FTE in the residence state
- By reason of fiscal transparency, the amount received is not treated under the residence state the same as if not fiscally transparent

- 3rd element not violated in either fact pattern
- CRA has stated that geographic source of payment need not be same



Paragraph 7(b) – Inbound



*considered a branch of CAN Co under Canadian tax law

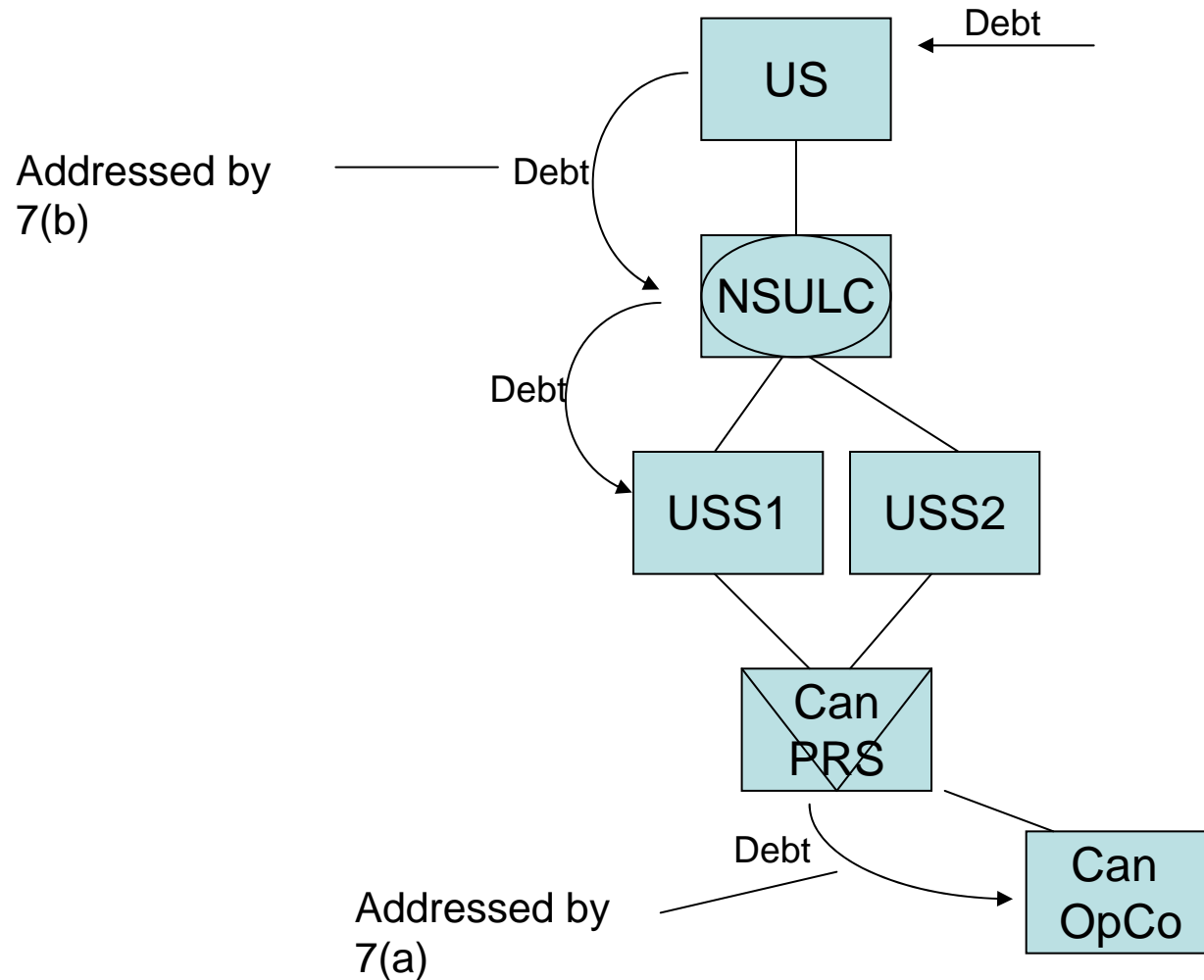
Paragraph 7(b) Test

- US sees dividend by US resident (corp)
- CAN sees US LP as an FTE
- Treatment to CAN Co not the same under CAN law if US LP is regarded for CAN purposes (dividend)

- Because US LP is a branch of CAN Co, the same result obtains – i.e., not paid to or derived by CAN Co if the payment is an interest or royalty payment.



“Tower” Structure - Revisited



ULCs

- Corporations
 - Historical accident
- Why use?
 - U.S. Tax system
 - No Canadian tax reason to use
- Nova Scotia historically, recently Alberta and B.C.



ULCs

- 5th Protocol surprise: Article IV(7)(b):

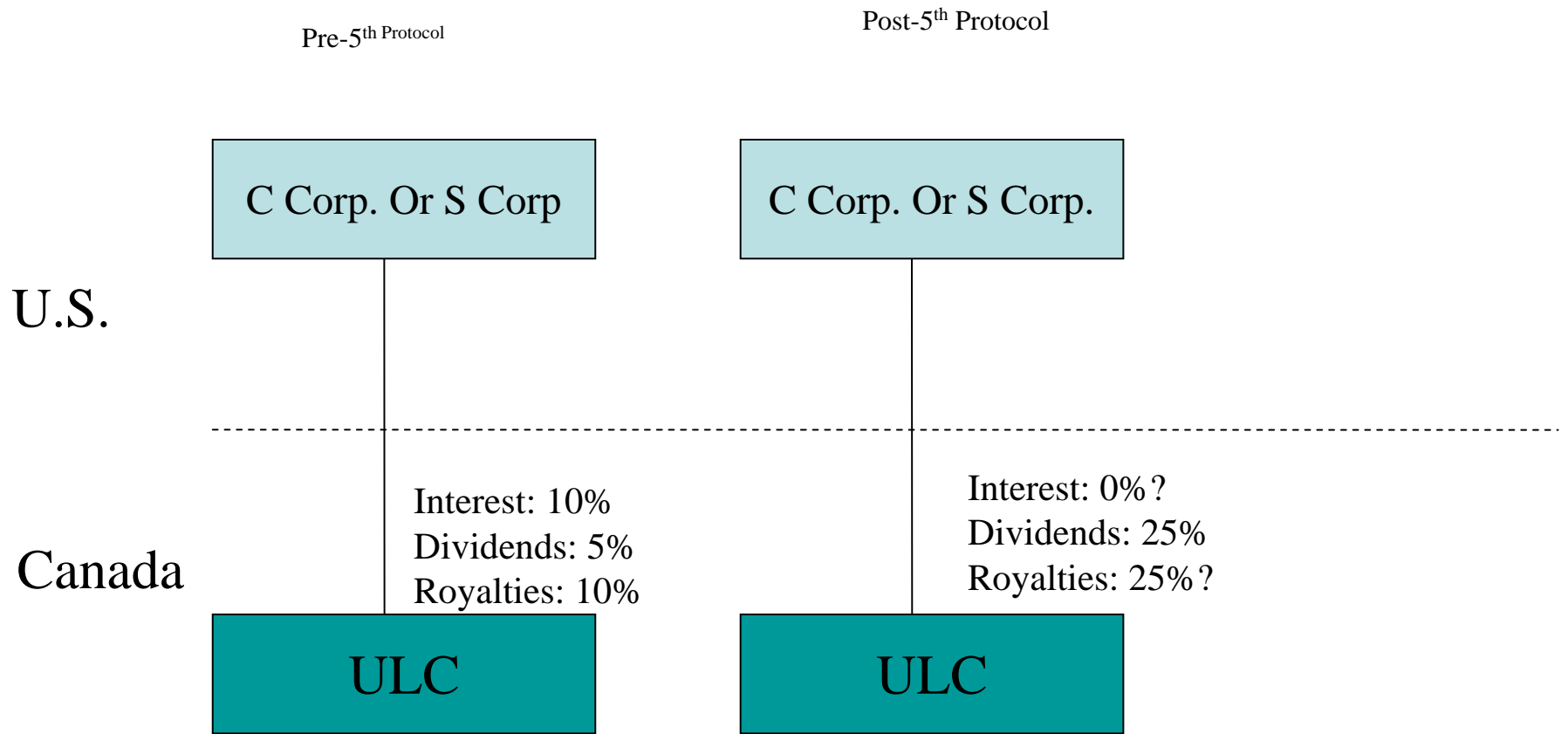
7. An amount of income, profit or gain shall be considered not to be paid to or derived by a person who is a resident of a Contracting State where:

...

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



ULCs



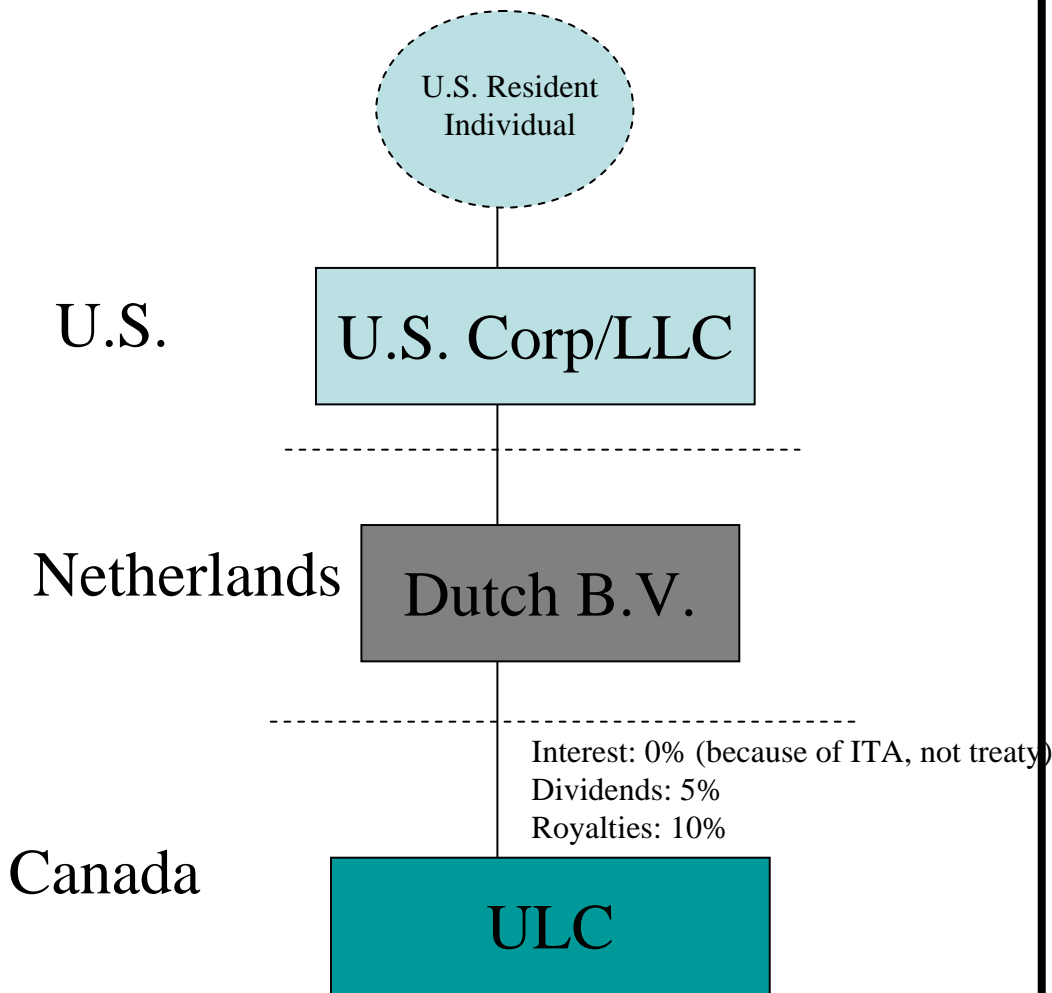
Solutions to ULC problem

- Increase paid-up capital (which is a deemed dividend in Canada) followed by return of capital
- Invest through Dutch B.V.
- Hybrid instruments

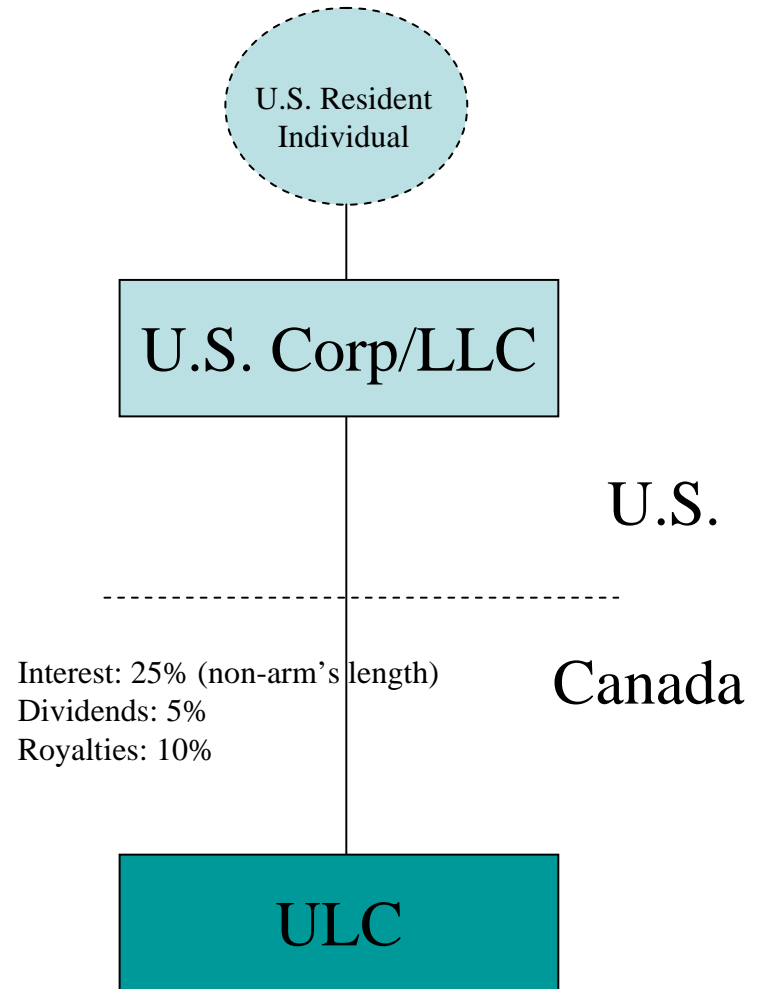


ULCs cont'd

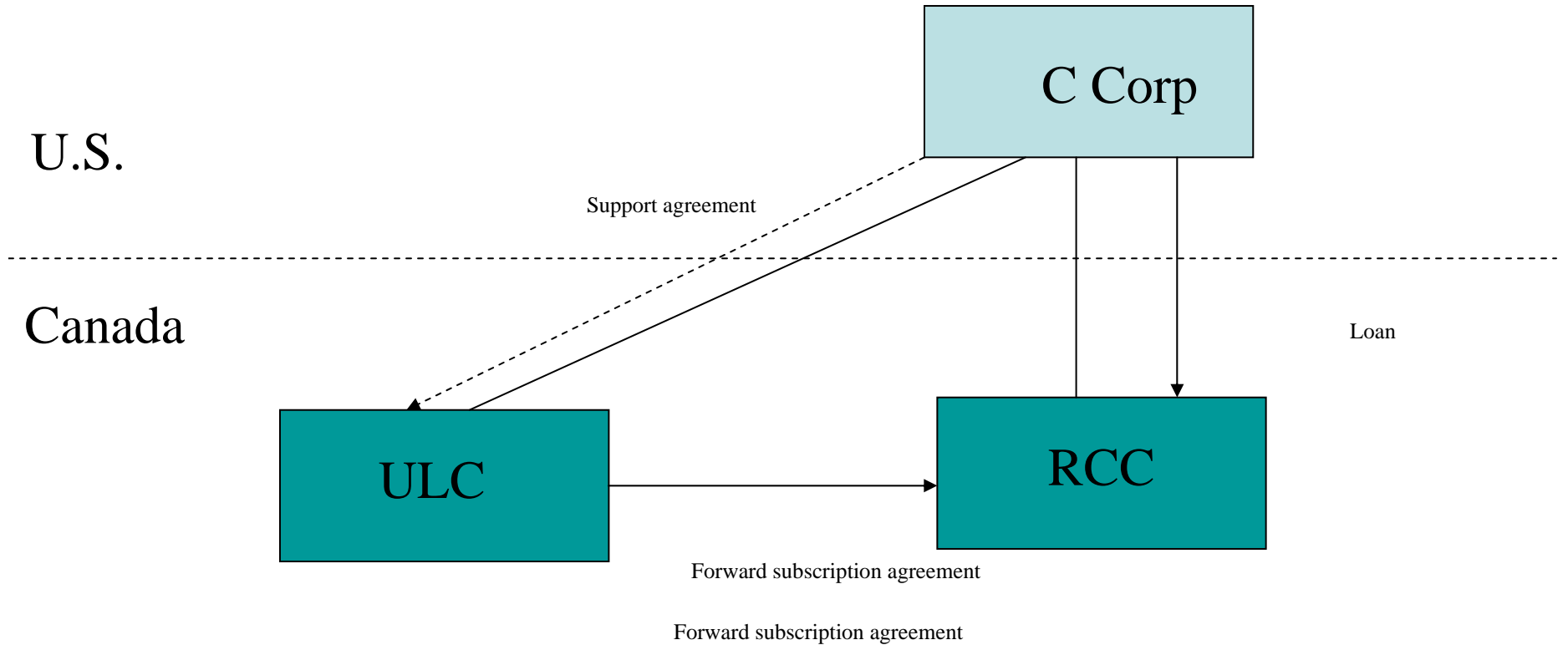
Dutch Structure



Paid-up capital/return of capital



Hybrid Instrument



Article IV(7): U.S. Partnerships

- Canada's Income Tax Conventions Interpretation Act states that a partnership is not considered a resident
- Nonetheless, CRA opens door to say that U.S. partnership that is taxed as a corporation in U.S. can obtain treaty benefits.



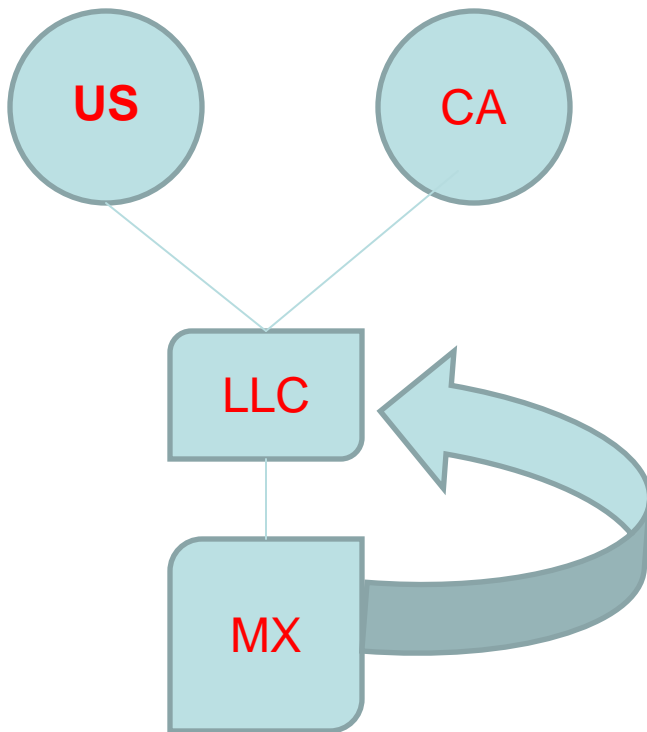
Outstanding issues

- Applicability of TD Securities today
- Planning with S Corps
- Treaty interpretation
 - Beneficial owner, entity
 - Whose PE?
- U.S. Partnerships taxed as corporations
- Canadian opinions will rely on U.S. opinions regarding U.S. law



Mexico - LLCs

- Treaty protection

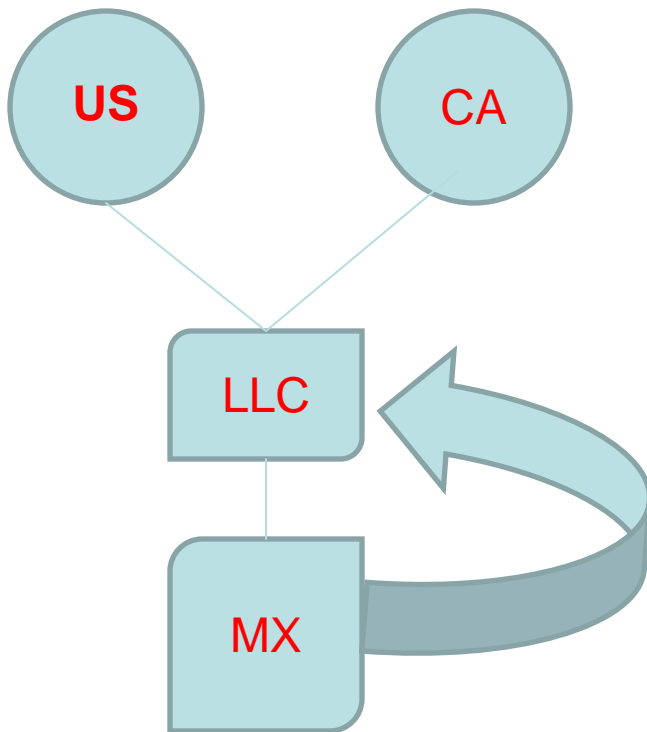


- Royalty payments from MX to LLC
 - USA-MX DTC protection to US as per Mutual Agreement. 10% withholding to attributable part
 - CAN-MX no DTC protection CAN LLC subject to 25% or 40% withholding on the part attributable to CA



Mexico - LLCs

- Treaty protection



Sale of MX shares by LLC

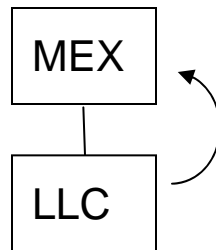
US-MX DTC Art. 13 25% interest /
prior 12 month rule applicable to US
or

Mex-Can DTC Art. 13 25% interest /
prior 12 month rule applicable to
CAN LLC



Mexico - LLCs

- Mexican Member in a LLC. Denial of Mexican tax credit of any income tax paid by the Member in the U.S.



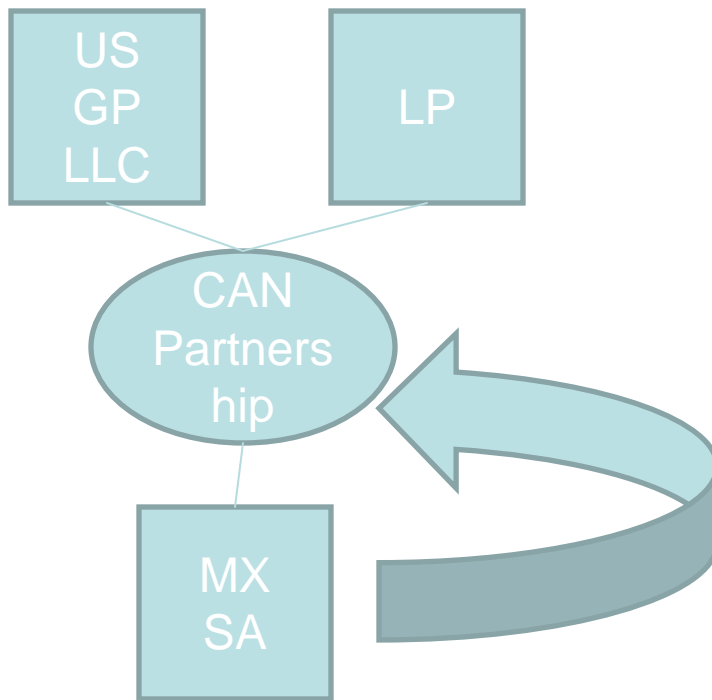
Income obtained by LLC that is attributable to MEX, if taxed in U.S., could not be credited in MEXICO.

Mexican Income Tax law requires that the income taxed in the U.S. to be accruable by MEX for purposes of its Mexican Income Tax. No recognition of tax transparency



Mexico- CAN Partnership

Can Partnership = legal figure not legal entity. Recognized as such for Mexican legal purposes



- Can Partnership= not tax resident for purposes of the MX-CAN DTC

- Legal nature of Can Partnership recognized also for tax purposes in Mexico.

 - Mexican tax authorities rulings.

- US-MX DTC and other DTC benefits applicable to GP/LP



Mexico – Can Partnership

- Sale of MX shares by Can Partnership
 - Can partnership not a legal entity. However it has separate patrimony.
 - Which basis should apply ?
 - The amount contributed by the LP to the Partnership.
 - The amount contributed by the LP to MX SA



Mexico – Can Partnership

General partner located in Mexico

- CAN Partnership is considered as a “joint venture” –*asociación en participación*- with tax residence in Mexico and tax as a Mexican entity?
- Creation of a Permanent establishment?

