

# **Withholding Tax, Treaty and Transfer Pricing Issues Case Study**

Maralynne Monteith  
Blake Murray  
Christopher Steeves

# Capitalisation and Financing

- Where are the parties resident?
  - Cansub is a Canadian resident
    - What type of entity is Cansub?
  - Is the U.S. Parent a treaty resident?
    - What type of entity is the U.S. Parent?
  - Is the U.S. Bank a treaty resident?
    - What type of entity is the U.S. Bank?

# Cansub Borrows from U.S. Parent

- Provided U.S. Parent is resident of the U.S. for purposes of the Treaty, no withholding tax on interest
  - Consider Article IV, para. 6 and 7
  - Limitation on Benefits
- is interest reasonable?
  - s.15(1) and 214(3)(a) deemed dividend
  - deductibility
- s.247 transfer pricing rules
- s.15(1) and 214(3)(a) – Canadian subsidiary cross-guarantee
- U.S. tax consequences

# Cansub Borrows from U.S. Bank

- arm's length corporate borrowing qualifies for exemption from withholding tax, depending on loan terms discussed below
- s.214(15)(a) will apply if Cansub pays a guarantee fee to its U.S. Parent – fee would be deemed interest.
  - Fifth Protocol will impact
- U.S. tax considerations?
- Other:
- standby fees relating to the term loan (but not the revolving line) paid to U.S. Bank should be free of withholding tax – s.214(15)(b).

## Cansub Borrows from U.S. Bank's Canadian Sub

- no cross-border interest payments, no non-resident withholding tax
- post-default issues created by U.S. security
  - governing law, enforceability
  - if U.S. pays arrears or accruing interest, will it be subject to U.S. withholding tax?

# Term Loan from U.S. Bank – Arm's Length?

- Are interest payments eligible for Treaty relief?
- s. 251 – meaning of arm's length for purposes of the Act
  - Related person are deemed to be non-arm's length – s. 251(2) to 251(6) defines related persons
  - Deeming rule for personal trusts and beneficiaries
  - Otherwise – question of fact whether unrelated persons deal with each other at arm's length
- Factors which might demonstrate non-arm's length relationship between U.S. Bank and Cansub
  - Members of the board of directors?
  - Terms of the loan?

# **Term Loan from U.S. Bank** **with Participating Interest**

- Interest computed by reference to dividends of Cansub
  - s. 212(3) - participating debt interest – computed by reference to dividends paid to shareholders of any class of shares of a corporation
- Interest computed by reference to dividends of the U.S. Parent
  - s. 212(3) – participating debt interest – however, under the Fifth Protocol – Article XI paragraph 6(b) - to be subject to withholding tax interest must be computed by reference to dividend payment made by the debtor to a related person

# Term Loan from U.S. Bank Guaranteed by U.S. Parent

- Cross guarantee:
  - does 214(3)(a) apply to outbound upstream guarantee?
    - value of guarantee?
    - existence and value of consideration?
- Other:
  - if the U.S. Parent pays a fee for the upstream guarantee, are there U.S. withholding tax concerns?



# Interest at 120% of U.S. Bank Rate

- Ambiguously worded Bank rate
- If borrowed from U.S. Parent, is this rate a reasonable arm's length rate or is there a non-deductible deemed dividend, etc.?
- If borrowed from U.S. Bank or its Canadian subsidiary, reasonableness issue does not appear to arise.
- 100% vs 120%? How to decide?
- The cost to the Cansub of a gross-up provision with the U.S. Bank would be cheaper than the cost of borrowing from the Canadian bank.

# Dividends

- Treaty rate for dividends to U.S. corporation holding shares of Cansub with 10% or more of the votes is 5%
- Consider Limitation on Benefits
- Consider Article IV – para. 6 and 7
  - CRA has issued statements which describe two-step process (PUC increase with a return of capital) which provides an effective “work-around”
  - Similar work-arounds announced for deductible payments

# SERVICE ARRANGEMENTS

- Administrative Services:
  - S. 247 transfer pricing rules
  - S. 212(1)(a)
  - S. 212(4) and IT-468
  - S. 153(1) and Reg 105?
  - US Treaty Article VII
  - Cost-plus formula—issues?

# US & HONG KONG EMPLOYEES

- S. 2(3)(a)
- S. 153(1) and Reg 105
- Articles VII and XV US Treaty
- Does Hong Kong company carry on business in Canada?
- Does US company? Does it have a PE?
  - Fifth Protocol – new Article V para. 9(b)

# TRADENAME & TRADEMARK LICENCES

- Annual fee: s. 212(1)(d)(i)
- Article XII US Treaty rate reduction
- S. 247 transfer pricing

# SOFTWARE LICENCES

- For Own Use:
  - Article XII(3)(b) applies even if NAL
  - S. 247 transfer pricing
- To Reproduce:
  - Withholding tax as above—see also s. 212(1)(d)(vi) copyright exemption
  - S. 247 transfer pricing
  - Consider contract manufacturing software for US parent

# OTHER ISSUES

- PST on software
- GST/HST
  - Does self-assessment apply?