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DOCNUM 2013-0486931E5

REFDATE 140212

SUBJECT Distribution by ULC to a Trust to a NR beneficiary

SECTION ITA: 212(1)(c)(ii), 84(1); Canada-U.S. Treaty: Art. IV(7)(b), Art. XXII(2)

PRINCIPAL ISSUES: 1. Will subparagraph (7)(b) of Article IV of the Canada-U.S. Treaty apply to a distribution of dividend income received from a ULC, made by a Canadian trust to a U.S.-resident beneficiary?
2. If the answer to question 1 is in the affirmative, will a deemed dividend from the ULC created pursuant to subsection 84(1) of the Income Tax Act get around the application of subparagraph (7)(b) of Article IV of the Canada-U.S. Treaty?
POSITION: 1. Yes. 2. No
REASONS: 1. Since the U.S. tax treatment of the amount paid from the trust is not the same as a result of the fiscal transparency status of the trust compared to when it is not treated as fiscally transparent, subparagraph (7)(b) of Article IV of the Canada-U.S. Treaty applies and the non-resident beneficiary would not be entitled to the benefits of the Treaty.
2. It is irrelevant whether a deemed dividend is created under subsection 84(1) of the Act by having the ULC increase the PUC of its shares and thereafter reducing the PUC, and making a distribution of cash as a

return of capital. What must be considered in an analysis under subparagraph (7)(b) of Article IV of the Canada-U.S. Treaty is whether from a U.S. tax perspective, there would be a difference in treatment of the trust distribution when the trust is treated as fiscally transparent and when it is not fiscally transparent. As there is a difference in treatment in such instance, subparagraph (7)(b) of Article IV of the Canada-U.S. Treaty will not be avoided.

XXXXXXXXXX

2013-048693

Henry Leung

(613) 957-2129

February 12, 2014

Dear XXXXXXXXXX,

Re: Subparagraph (7)(b) of Article IV of the Canada-U.S. Treaty (the "Treaty")

This is in response to your e-mail dated April 25, 2013. We apologize for the delay in responding to your e-mail.

Your request describes the following hypothetical facts:

* The Trust is resident in Canada throughout the year;
* The Trust is not subject to the provisions of subsection 75(2) of the Income Tax Act (the "Act");
* The Trust has one individual beneficiary (the "Non-resident

Beneficiary") who is a non-resident of Canada for Canadian tax purposes and is a resident of the U.S. for the purposes of the Treaty. The Non-resident Beneficiary is a qualifying person for the purposes of the Treaty;

* The Trust is a sole-shareholder of an Unlimited Liability Company ("ULC"), which is resident in Canada for the purposes of the Treaty;
* The Trust and the ULC are considered fiscally transparent for U.S. tax purposes;
* The ULC will pay a dividend to the Trust and then the Trust will make a distribution to the Non-resident Beneficiary and deduct it pursuant to subsection 104(6) of the Act;
* Subject to the Treaty, a 25% withholding tax is imposed on the Non-resident Beneficiary for amounts paid or credited as income distributed from a trust to the Non-resident Beneficiary pursuant to subsection 212(11) and paragraph 212(1)(c) of the Act.

You ask the following questions:

1. Will subparagraph (7)(b) of Article IV of the Treaty apply to the distribution by the Trust to the Non-resident Beneficiary? If subparagraph (7)(b) of Article IV of the Treaty did not apply, paragraph (2) of Article XXII of the Treaty would reduce the withholding tax rate on the gross amount of the income distributed by the Trust to the Non-resident Beneficiary to 15%.

2. If the response to question 1 above is in the affirmative, will a deemed dividend caused by an increase in the paid-up-capital (PUC) of the ULC shares, followed by a reduction in the PUC in the same amount of those shares, along with a distribution of cash as a return of capital equal in amount to the reduction, avoid the application of subparagraph

(7)(b) of Article IV of the Treaty?

Our Comments:

This technical interpretation provides general comments about the provisions of the Income Tax Act and related legislation (where referenced). It does not confirm the income tax treatment of a particular situation involving a specific taxpayer but is intended to assist you in making that determination. The income tax treatment of particular transactions proposed by a specific taxpayer will only be confirmed by this Directorate in the context of an advance income tax ruling request submitted in the manner set out in Information Circular IC 70-6R5, Advance Income Tax Rulings.

Applicability of subparagraph (7)(b) of Article IV of the Treaty:

Subparagraph (7)(b) of Article IV of the Treaty states:

An amount of income, profit or gain [distribution from the Trust] shall be considered not to be paid to or derived by a person [Non-resident Beneficiary] who is a resident of a Contracting State [U.S.] where:
(a) ...
(b) the person [Non-resident Beneficiary] is considered under the taxation law of the other Contracting State [Canada] to have received the amount [distribution from the Trust] from an entity [Trust] that is a resident of that other State [Canada], but by reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State [U.S.], the treatment of the amount under the taxation law of that State [U.S.] is not the same as its treatment would be if that entity were not treated as fiscally transparent under the laws of that State

[U.S.].

In making an analysis under subparagraph (7)(b) of Article IV of the Treaty, what needs to be considered is the U.S. tax treatment of the amount of income (in this case, the distribution from the Trust) paid to the Non-resident Beneficiary when the Trust is fiscally transparent for U.S. tax purposes and when it is not. When a trust is fiscally transparent under the tax laws of the U.S., such as the one in this case, the distribution from a trust to a non-resident beneficiary would not be a taxable event for U.S. tax purposes. Moreover, as the ULC is a disregarded entity, there is no flow through (the Trust) of dividends from the ULC to the Non-resident Beneficiary from a U.S. tax perspective. Rather, the Non-resident Beneficiary would be seen as simply earning directly the income that the ULC earns.

Since we have not been provided with any information on how the U.S., for U.S. tax purposes, treats distributions from a trust that is not fiscally transparent, it is uncertain how subparagraph (7)(b) of Article IV of the Treaty will operate in this particular case. With that said, in determining whether the U.S. treatment of the Trust distribution to the Non-resident Beneficiary is the same for the purposes of applying subparagraph 7(b) of Article IV of the Treaty if the Trust is not fiscally transparent for U.S. tax purposes, we will refer to:

(i) the timing of the recognition/inclusion of the amount,

(ii) the character of the amount, and

(iii) the quantum of the amount.

For U.S. tax purposes, assuming that trust distributions are treated in a similar way to how trust distributions are treated under the Act, if the Trust is not viewed as fiscally transparent, then the Non-resident

Beneficiary would be seen to receive a trust distribution from the Trust which the Non-resident Beneficiary would be required to include in income. In sum, on the one hand when the Trust is treated as fiscally transparent, the distribution to the Non-resident Beneficiary would be completely ignored for U.S. tax purposes and when the Trust is not fiscally transparent, the Trust distribution would be recognized for U.S. tax purposes and included in the computation of the income of the Non-resident Beneficiary. The treatment of the amount is different in all respects.

Since the amount paid from the Trust to the Non-resident Beneficiary is treated differently when the Trust is treated as fiscally transparent in the U.S. compared to when the Trust is not treated as fiscally transparent in the U.S., subparagraph (7)(b) of Article IV of the Treaty applies, and the Non-resident Beneficiary will not be entitled to the benefits of the Treaty. Accordingly, the Non-resident Beneficiary will be subject to the full withholding tax rate of 25% on distributions made by the Trust pursuant to subsection 212(11) and paragraph 212(1)(c) of the Act.

Increasing the PUC of the ULC Shares:

You ask whether the application of subparagraph (7)(b) of Article IV of the Treaty can be avoided if a deemed dividend under subsection 84(1) can be created by increasing the PUC of the ULC shares, followed by a reduction in the PUC in the same amount of those shares, along with a distribution of cash from ULC to Trust as a return of capital equal to the reduction.

As mentioned above, for the purposes of an analysis under subparagraph

(7)(b) of Article IV of the Treaty, what needs to be considered is how the distribution from the Trust paid to the Non-resident Beneficiary is treated when the Trust is considered fiscally transparent compared to when it is not fiscally transparent under the taxation laws of the U.S. The analysis of the U.S. tax treatment does not focus on the amount moving between the ULC and the Trust regardless of whether the Trust is fiscally transparent. Thus, any deemed dividend created by the ULC cannot affect the analysis.

We trust these comments to be of assistance.

Yours truly,

Olli Laurikainen, CPA, CA

For Director

International Division

Income Tax Rulings Directorate