Docket: 2008-2314(IT)G

BETWEEN:

TD SECURITIES (USA) LLC,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on January 20, 21 and 22, and on February 2, 2010,
at Toronto, Ontario.

Before: The Honourable Justice Patrick Boyle

Appearances:

Counsel for the appellant:	Al Meghji Patrick Marley Pooja Samtani
Counsel for the respondent:	Elizabeth Chasson H. Annette Evans Brandon Siegal

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JUDGMENT

The appeal from the assessments made under the *Income Tax Act* with respect to the appellant's 2005 and 2006 taxation years is allowed, with costs, in accordance with the Reasons for Judgment attached hereto.

Signed at Toronto, Ontario, this 8th day of April 2010.

"Patrick Boyle"

Boyle J.

Citation: 2010 TCC 186
Date: 20100408
Docket: 2008-2314(IT)G

BETWEEN:

TD SECURITIES (USA) LLC,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Boyle J.

[1] The issue in this case is whether a limited liability company established in the United States (an "LLC") is entitled to enjoy the benefit of the *Canada-United States Income Tax Convention* (the "US Treaty") in respect of its Canadian-sourced income. Since the US Treaty is only applicable to residents of either country or of both countries, and the appellant is not a resident of Canada, the question in this case narrows to whether the appellant is a resident of the United States (the "US") for purposes of the US Treaty. The Fifth Protocol entered into between Canada and the United States amended the US Treaty to add specific rules that apply to LLCs and other fiscally transparent entities including partnerships (the "Fifth Protocol Amendments"). However the Fifth Protocol Amendments were adopted and came into force after the periods in question.

I. Facts

[2] The appellant, TD Securities (USA) LCC ("TD LLC") is a limited liability company governed by the *Limited Liability Company Act* of the State of Delaware.

[3] The sole member of TD LLC is TD Holdings II Inc. ("Holdings II") a Delaware corporation that is not resident in Canada for purposes of the *Income Tax*

Act (the “Canadian Act”) and is a resident of the US for purposes of the US Treaty. TD LLC’s predecessor entity, TD Securities USA Inc., was a Delaware corporation. In 2004 TD Securities USA Inc. was converted into a LLC and renamed TD LLC. This conversion was a tax-deferred non-recognition transaction under the US *Internal Revenue Code* (the “US Code”). The reorganization was done to allow a consolidation of the losses and gains of the subsidiaries of Holdings II for US state income tax purposes.

[4] An LLC is a company that is recognized as a distinct legal entity separate from its members under Delaware and United States law. The parties agree that a US LLC is similarly recognized as a distinct legal entity separate from its members under Canadian law. The appellant does not contest that TD LLC should be treated as a corporation under Canadian law. The Court was not invited by either party to revisit the characterization issue.

[5] Holdings II is a wholly-owned direct subsidiary of Toronto Dominion Holdings (USA) Inc. (“TD USA”), another Delaware corporation. TD USA is a wholly-owned direct subsidiary of The Toronto-Dominion Bank, a Canadian chartered bank.

[6] TD LLC is a registered US broker-dealer that provides financial services in the capital markets sector such as foreign exchange trading and interest rate swaps. It has carried on its business since the mid to late 1970s. It is based in New York City because that is where its business can best be transacted and that is where most of its customers are located or headquartered. Its headquarters are in New York City. It has over 500 employees.

[7] TD LLC has a branch operation in Canada for the purpose of serving its US customers. Given the regulation of the financial services sector in both countries, its US customers need or prefer to do business in Canada with a US company.

[8] TD LLC’s Canadian branch profits for 2005 and 2006 were reported by it in its Canadian tax returns. Non-residents of Canada that carry on business in Canada are subject to ordinary Canadian income tax under Part I of the Canadian Act on the income from their Canadian business activity. The US Treaty provides that a US resident that carries on business in Canada is only subject to Canadian income tax if the business is carried on through a permanent establishment (“PE”) in Canada. There is no dispute that TD LLC’s Canadian branch satisfies the definition of a PE.

[9] Part XIV of the Canadian Act also provides that a non-resident carrying on business in Canada will be liable for an additional tax of 25% of its Canadian net after-tax income. This is commonly called “branch tax”. Its serves as the equivalent of the 25% Canadian non-resident withholding tax on dividends levied under Part XIII of the Canadian Act that would have been payable if the non-resident had carried its Canadian business through a Canadian subsidiary corporation, instead of directly through a branch, and had paid a dividend equal to its net after-tax income. In this way, the Canadian tax consequences are generally the same for non-residents of Canada whether their Canadian business is carried on through a Canadian subsidiary or a Canadian branch.

[10] Part XIV of the Canadian Act provides that, if a Canadian tax treaty with the country of residence of a non-resident carrying on business in Canada through a branch provides for a lesser withholding tax rate on dividends than 25%, the 25% rate under Part XIV is similarly reduced[1] unless the treaty itself reduces the rate under Part XIV. The US Treaty expressly provides[2] that the rate of Canadian Part XIV tax for Canadian branches of US residents is reduced to the same 5% rate applicable under the US Treaty to dividends paid by a wholly-owned Canadian subsidiary to its US parent. TD LLC claimed the reduced rate of Canadian branch tax of 5% under the US Treaty in respect of the 2005 and 2006 income of its Canadian branch.

[11] The Canada Agency Revenue (“CRA”) assessed TD LLC to deny it the benefit of the 5% US Treaty rate of branch tax and assessed Part XIV branch tax at the statutory rate of 25%.

[12] The US Code taxes individuals based upon citizenship or residence. It does not use the concept of residence to levy income tax on corporations. Under the US Code corporations are divided into domestic and foreign corporations. Domestic corporations, those established, organized or incorporated in the US, are generally subject to tax on their worldwide income whereas foreign corporations, those that are not domestic corporations, are not subject to worldwide tax but are taxed on their US-sourced income.

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[1] See section 219.2 of the Canadian Act. It is interesting to note that section 219.2 does not require that a treaty apply to a particular taxpayer. Thus, had Article X of the US Treaty dealing with the withholding tax rate on dividends not included paragraph 6 dealing expressly with the rate of Canadian branch profits tax, Part XIV of the Canadian Act would only have levied a 5% tax on TD LLC under the express terms of the statute.

[2] See paragraph 6 of Article X of the US Treaty dealing with Dividends.

[13] Under the US Code an LLC is entitled to elect to be treated as either (i) a corporation subject to US federal income tax like any other US domestic corporation, or (ii) a flow-through or disregarded entity whose income will be flowed through to its member or members. If it elects to be disregarded and it has more than one member, the LLC will be regarded as a partnership for US federal income tax purposes[3]. Under the US Code, as under the Canadian Act, the income of a partnership is required to be allocated amongst its partners and included in income at the partner level. If an LLC elects to be disregarded and has only one member, its activities will be treated in the same manner as a sole proprietorship, branch, or division of the member. If an LLC does not file an election under the so-called "check-the-box" regulations, it will be deemed to have elected to be a disregarded flow-through entity.

[14] Under the US Code both a partnership and a disregarded LLC are treated as a pass-through entity, that is an entity that is not taxed at the entity level but is taxed at the level of the owners of the entity.[4]

[15] TD LLC did not file an election under the "check-the-box" regulations. Accordingly, under the US Code it is a disregarded entity and it is not itself subject to tax on its income. Instead, all of its income is required to be included in the income of its sole member, Holdings II, as if the activities of TD LLC were carried on directly by Holdings II. The 2005 and 2006 income of TD LLC's Canadian branch was included in the income of Holdings II in this manner under the US Code.

[16] The income of Holdings II is consolidated with the income of its direct parent, TD USA, under the US Code provisions for consolidated returns by US parent corporations. In this way, TD USA pays US tax on all of the income computed under the US Code for Holdings II. This includes all of the income of TD LLC, just as it did prior to the reorganization when TD LLC was a corporation wholly-owned by Holdings II. Under the provisions of the consolidated group's tax reimbursement agreement, the taxes payable by TD USA under the US Code on the earnings of Holdings II and TD LLC are charged back to, and borne by, each of Holdings II and TD LLC being the entities that earned the income giving rise to the tax.

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[3] Such a disregarded entity is not completely disregarded for all purposes under the US Code. For certain income tax procedural purposes and for certain non-income tax purposes (such as social security taxes and excise taxes) under the US Code it is not disregarded.

[4] The US Code's so-called "check-the-box" regulations permit most entities other than *per se* corporations, and including US partnerships, to elect between corporate and pass-through treatment.

[17] TD USA was unable to claim a full foreign tax credit in its consolidated US return under the US Code in respect of the Part XIV branch tax payable on the Canadian income of TD LLC. TD USA was subject to the limitations on foreign tax credits under the US Code that relate to the comparable US rate of taxation on foreign-sourced income. Thus, the assessments in question increased the combined US and Canadian tax imposed on the Canadian-sourced income of TD LLC.

[18] Three experts on US taxation law testified, one called by the appellant and two by the respondent. They agreed on how the income of LLCs and partnerships is subject to tax under the US Code generally, and on how the income of TD LLC would have been taxed in the US in its particular circumstances. These are as summarized above.

[19] The expert called by the appellant differed in his views from those of the experts called by the respondent as regards whether, at the relevant time, the US Internal Revenue Service ("IRS") would have interpreted the term "resident of a Contracting State" under the US Treaty to include a Canadian flow-through entity or other disregarded entity in comparable circumstances. Based upon the expert evidence presented, the Court is unable to conclude as a matter of fact whether or not the IRS would have regarded a Canadian flow-through entity in those years as a resident of Canada for purposes of the US Treaty entitled to treaty benefits in respect of any of its US-sourced income. It appears from each of the three experts that the IRS and the US never made such a determination. In addressing this question the experts instead addressed what they thought the IRS would have done if it was required to make such a determination based upon US legal and administrative positions in related areas. The information provided by the experts in their reports and in their testimonies was helpful, factual evidence as described in greater detail below.

[20] The expert reports filed by the respondent included questions and answers phrased in terms of the very question to be determined by this Court as a matter of Canadian law, i.e., whether TD LLC was a resident of the US for purposes of the US Treaty. Appellant's counsel took initial exceptions to the reports on this basis. Both of the respondent's reports were admitted into evidence as expert opinion evidence because the information contained in their written reasoning working towards their answer was itself very helpful and informative factual evidence of US law and IRS practice and that information was admissible expert opinion evidence. The respondent's expert opinions have been disregarded in so far as they are opining on what this Court's answer should be to the question before it.

[21] There was no evidence whether TD LLC and/or Holdings II requested the assistance of the US competent authority as provided for in the US Treaty to resolve their treaty dispute nor, if so, what the positions of the US and Canadian competent authorities were, nor what the outcome was.

II. Positions of the Parties

[22] It is the respondent's position that the meaning of the phrase resident of a Contracting State set out in the US Treaty is clear and unambiguous and that the evidence is clear that TD LLC was not itself liable to tax in the US. The respondent maintains that the meaning of the language chosen by two countries to define to whom the US Treaty applies cannot be interpreted in a manner which will entitle TD LLC to the benefits of the treaty without either ignoring some of the words used or reading some words into it. As the respondent argued, treaties should be interpreted liberally and purposively but, in the end, effect must be given to the words chosen.

[23] The respondent further maintains that, even if TD LLC is considered to be liable to tax in the US by virtue of its income being taxed to Holdings II, that tax is not "by reason of [TD LLC's] domicile, residence, place of management, citizenship, place of incorporation or any other criterion of a similar nature" as required by Article IV of the US Treaty.

[24] The respondent also maintains that, if TD LLC is successful, LLCs will, in the future, be able to claim treaty relief on the same basis instead of on the basis of the Fifth Protocol Amendments. The respondent is concerned that this will be an inappropriate result since the Fifth Protocol Amendments have set out specific conditions which must be met to claim relief which would be rendered meaningless if a US LLC could claim relief otherwise than under paragraphs 6 and 7 of Article IV added by the Fifth Protocol Amendments.

[25] The appellant has two distinct bases which it puts forth to support its claim for treaty relief for the Canadian-sourced income of TD LLC.

[26] The appellant's first position is that the phrase "liable to tax in" the US is a phrase which is not defined in the US Treaty and which therefore falls to be defined by this Court by reference to Canadian law, and is different from the mere determination whether a person is required to pay tax on its income under the US Code. The appellant submits that, on this basis, this Court can conclude that TD LLC

was liable to tax in the US and hence was a resident of the US for purposes of Article IV.

[27] The appellant's alternative argument is that, consistent with the commentaries to the relevant provisions of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development (the "OECD and the OECD Model Treaty"), which commentaries neither Canada nor the US reserved upon nor made material observations, a liberal interpretation and application of the US Treaty designed to achieve its purpose must give a meaning to the phrase "resident of a Contracting State" that includes a US LLC such as TD LLC. In addition to the OECD commentaries, the appellant relies upon the 1999 OECD report on the Application of the OECD Model Tax Convention to Partnerships (the "OECD Partnership Report").

III. Analysis, Law and Authorities

A. *The US Treaty Provisions*

[28] The US Treaty was entered into by Canada and the US in 1980 and came into force in 1984. It replaced a previous income tax convention between the two states.

[29] Article I of the US Treaty provides that the Convention ". . . is generally applicable to persons who are residents of one or both of the Contracting States."

[30] Article II provides that the Convention ". . . shall apply to taxes on income and on capital imposed on behalf of each Contracting State, irrespective of the manner in which they are levied".

[31] Article III of the US Treaty sets out the definitions applicable for purposes of the Convention ". . . unless the context otherwise requires".

[32] Person is defined in Article III to include ". . . an individual, an estate, a trust, a company and any other body of persons". Company is defined to mean ". . . any body corporate or any entity which is treated as a body corporate for tax purposes".

[33] It is not disputed that TD LLC is a person as defined. It is not clear if the Court needs to decide if it is a company but it appears that, for purposes of applying the US Treaty in Canada, TD LLC is a company since Canada treats such an LLC as a body corporate for purposes of the Canadian Act.

[34] The US Technical Explanation to the treaty issued by the US Treasury Department in 1984 expressly confirms that a partnership is a person for this purpose. The Canadian Minister of Finance indicated by press release that the US Technical Explanation accurately reflects understandings reached in the course of negotiations with respect to the interpretation and application of the US Treaty.[5] Little purpose is advanced by confirming that a partnership is a person if not to confirm that a partnership's income can qualify for treaty benefits. It would hardly warrant express mention in the Technical Explanation otherwise.

[35] Article III goes on to provide that "[a]s regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires and subject to the provisions of Article XXVI (Mutual Agreement Procedure), have the meaning which it has under the law of that State concerning the taxes to which the Convention applies." Section 3 of the *Income Tax Conventions Interpretation Act* is to a similar effect. In other words, in these proceedings, this Court is to give any term used in the US Treaty and not defined therein the meaning that term has in Canadian law for purposes of the Canadian Act unless the context otherwise requires.

[36] Article IV deals with residence. It provides that ". . . the term 'resident' of a Contracting State means any person that, under the laws of that State, is liable to tax therein by reason of that person's domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature, . . .".

[37] The definition carries on ". . . but in the case of an estate or trust, only to the extent that income derived by the estate or trust is liable to tax in that State, either in its hands or in the hands of its beneficiaries." Under the US Code, as under the Canadian Act, the income of an estate or trust may flow out to its beneficiaries for tax purposes in certain circumstances. Thus, the US Treaty assumes that an estate or trust can satisfy the definition, but places a specific restriction thereon.

[38] Subparagraph (*b*) of the definition of resident of a Contracting State provides that it includes not-for-profit organizations and pension funds that were constituted in a contracting state and generally exempt from income taxation in that state by reason of their status. This part of the definition was added to the US Treaty by the Third Protocol in 1995. The 1995 Technical Explanation to the Third Protocol issued by the

[5] See Department of Finance Press Releases 81-16 dated February 4, 1981 and 84-128 dated August 16, 1984.

US Treasury Department[6] describes the addition as a clarification that corresponded to the interpretation previously adopted by both Canada and the US. US not-for-profit organizations and pension funds would need to be residents of the US to obtain the general treaty-reduced rate of Canadian withholding tax on dividends and interest received on their Canadian investments. Further, Article XXI of the US Treaty provides certain not-for-profit organizations and pension funds with a complete exemption from Canadian withholding taxes on certain of their cross-border investments. The contracting states were able to interpret and apply the definition of resident of a contracting state to contextually require the recognition of not-for-profit organizations and pension funds as residents of their home country even though they do not generally pay income tax in their home country because they are exempt from tax.

[39] Similarly, the Third Protocol in 1995 added a clause which deemed the government of one of the countries or a political subdivision or local authority thereof, or an agency or instrumentality of any thereof, to be itself a resident of that state. The 1995 Technical Explanation describes this amendment as confirmatory in nature and "it is implicit in the current [pre-1995 Protocol] Convention and in other US and Canadian treaties, even where not specified". Treaty residence for government entities was necessary for them to get the general benefit of reduced withholding on cross-border investments and for public sector pension plans to enjoy the benefit of the Article XXI exemption as fully as private sector pension funds.

[40] These latter are both examples of where specific amendments to the definition of "resident of a Contracting State" were added to the US Treaty even though both countries agreed they were not needed, were confirmatory or clarifying in nature, and had interpreted and applied the pre-amendment treaty to treat such persons as residents as defined because the context required or because it was implicit.

[41] Article XXVI of the US Treaty deals with the Mutual Agreement Procedure between the Canadian and US competent authorities. It provides specifically that the competent authorities may, in trying to resolve any difficulties or doubts regarding the interpretation or application of the treaty, agree to the elimination of double taxation with respect to income distributed by an estate or trust in subparagraph (*e*), and to the elimination of double taxation with respect to a partnership in subparagraph (*f*). It also provides that the competent authorities may consult together

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[6] The Canadian Minister of Finance again indicated by Press Release 1995-048 dated June 13, 1995 that Canada had been given the opportunity to review and comment on the 1995 Technical Explanation and confirmed that it accurately reflects understandings reached in the course of negotiations with respect to the interpretation and application of the US Treaty.

for the elimination of double taxation in cases not provided for in the treaty. Subparagraph (*f*) dealing with partnerships was neither revised nor repealed when the Fifth Protocol Amendments were added.

B. *The Fifth Protocol Amendments*

[42] The Fifth Protocol Amendments were agreed to between Canada and the US in 2007. The Fifth Protocol Amendments specifically address how the US Treaty thereafter applies to fiscally transparent entities, such as partnerships and LLCs. This was accomplished by adding new paragraphs 6 and 7 to Article IV of the US Treaty as follows:

> 6. An amount of income, profit or gain shall be considered to be derived by a person who is 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.
>
> 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:
>
> > *(a)* The person is considered under the taxation law of the other Contracting State to have derived the amount through an entity that is not a resident of the first-mentioned State, but by reason of the entity not being treated as fiscally transparent under the laws of that State, the treatment of the amount under the taxation law of that 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 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.

[43] The Fifth Protocol Amendments are not retroactive and therefore do not apply to TD LLC’s 2005 and 2006 Canadian branch profits. That is not to say, however,

that they are irrelevant to the analysis of the issue. The two countries did not agree that the treaty did not previously apply to LLCs and other fiscally transparent entities such as partnerships. They have only specified that, subsequent to the coming into force of the Fifth Protocol Amendments, the treaty will be applicable to such entities on the basis set out and agreed.

[44] The US Treasury Department issued a Technical Explanation in respect of the amendments made to the treaty by the Fifth Protocol. The Canadian Minister of Finance has indicated publicly that Canada was given an opportunity to review and comment on the Technical Explanation to the Fifth Protocol and that "Canada agrees that the Technical Explanation accurately reflects understandings reached in the course of negotiations with respect to the interpretation and application of the various provisions in the Protocol."

[45] It is clear that the US did not agree with Canada's position that, absent the Fifth Protocol Amendments, the US Treaty did not extend to US LLCs. The Technical Explanation confirms this by its choice of language in its discussion of new paragraph 6 of Article IV: ". . . but for new paragraph 6 Canada would not apply the Convention in taxing the income."(Emphasis added) This sentence appears under the heading "Application of paragraph 6 and related treaty provisions by Canada". (Emphasis added)

[46] A perhaps surprising and relevant aspect of the Fifth Protocol Amendments is that they are not drafted in a manner that, applied literally, would resolve the problem faced by TD LLC or other US LLCs in later years to which the Fifth Protocol Amendments apply and this is acknowledged in the Technical Explanation. Under the Canadian Act, TD LLC is the legal entity that is the taxpayer required to prepare and file a Canadian income tax return in respect of its Canadian branch profits. The Fifth Protocol Amendments are clearly intended to ensure the LLC's income enjoys the benefits of the US Treaty. Yet, the Fifth Protocol Amendments do not provide that the LLC will be treated as a resident. To that extent TD LLC and other US LLCs will still not be able to get treaty relief if one seeks to apply the text of the treaty literally. Paragraph 6 provides that the income of an LLC or other fiscally transparent entity will be considered the income of its member, Holdings II in the case of TD LLC. That still does not address how, or strictly speaking why, the LLC would be able to claim the treaty reduction in its Canadian income tax return. The Canadian taxpayer will still be the LLC, not the member. The Fifth Protocol Amendments contemplate relief at the member level, Holdings II, not at the entity level; yet they do not by these terms deliver the contemplated relief if applied strictly and literally.

[47] This is instead dealt with quite differently by the agreement between the tax administrators of Canada and the US in the Technical Explanation. The Technical Explanation acknowledges that a literal application of new paragraph 6 does not resolve the problem. The Technical Explanation provides:

> If new paragraph 6 applies in respect of an amount of income, profit or gain, such amount is considered as having been derived by one or more U.S. resident shareholders of USLLC, and Canada shall grant benefits of the Convention to the payment to USLLC and eliminate or reduce Canadian tax as provided in the Convention. The effect of the rule is to suppress Canadian taxation of USLLC to give effect to the benefits available under the Convention to the U.S. residents in respect of the particular amount of income, profit or gain.
>
> However, for Canadian tax purposes, USLLC remains the only "visible" taxpayer in relation to this amount In other words, the Canadian tax treatment of this taxpayer (USLLC) is modified because of the entitlement of its U.S. resident shareholders to benefits under the Convention, but this does not alter USLLC's status under Canadian law. Canada does not, for example, treat USLLC as though it did not exist, substituting the shareholders for it in the role of taxpayer under Canada's system.
>
> Some of the implications of this are as follows. First, Canada will not require the shareholders of USLLC to file Canadian tax returns in respect of income that benefits from new paragraph 6. Instead, USLLC itself will file a Canadian tax return in which it will claim the benefit of the paragraph and supply any documentation required to support the claim. (The Canada Revenue Agency will supply additional practical guidance in this regard, including instructions for seeking to establish entitlement to Convention benefits in advance of payment.). Second, as is explained in greater detail below, if the income in question is business profits, it will be necessary to determine whether the income was earned through a permanent establishment in Canada. This determination will be based on the presence and activities in Canada of USLLC itself, not of its shareholders acting in their own right.

[Emphasis added.]

[48] Like the earlier US Treaty amendments dealing with not-for-profit organizations and government entities, this is another example of the Canadian and US tax administrators interpreting and applying the chosen language of the treaty to deal with residence in a workable manner to achieve a result consistent with its purpose and context.

[49] What is even more telling with the Technical Explanation to the Fifth Protocol Amendments is that, as the two countries are turning their minds to the wording of

new provisions being drafted contemporaneously with the administrative provisions, they are content relying upon a sensible approach to the application and interpretation of the words and not the strict meaning or result of the words chosen for the treaty.

C. *The Interpretation of Treaties*

[50] The *Vienna Convention on the Law of Treaties*[7] provides that a treaty is to be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose. It also authorizes regard to subsequent practice in the application of the treaty in certain circumstances and for certain purposes, as well as the use of other supplementary means of interpretation when the interpretation of the treaty otherwise leads to a result which is manifestly absurd or unreasonable.

[51] It is fair to say that in this case there is a tension between the ordinary meaning of the terms used in the treaty and its object and purpose. This is a case where it *prima facie* appears that a strict application of the terms used to define resident of a Contracting State leads to an unreasonable result and thus, regard to supplementary means of interpretation is an appropriate part of the required analysis. The *prima facie* unreasonableness is demonstrated by, amongst other things, the fact that a strict application of the text would conflict with how both countries have interpreted and applied the treaty to government entities, not-for-profit organizations, pension funds and, as described below, partnerships which are themselves also fiscally transparent flow-through entities.

[52] In *The Queen v. Crown Forest Industries Limited et al.*, 95 DTC 5389, the Supreme Court of Canada had occasion to consider the appropriate interpretation to be given to the phrase "resident of a Contracting State" in Article IV of the US Treaty and, in particular, what it meant to be "liable to tax" in the US by reason of the enumerated criteria.

[53] The Court began from the premise that: "In interpreting a treaty, the paramount goal is to find the meaning of the words in question. This process involves looking to the language used and the intentions of the parties." The Court went on to quote approvingly from Addy J. in *Gladden Estate v. The Queen*, 85 DTC 5188, wherein he wrote at p. 5191:

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[7] See Articles 31 and 32.

> Contrary to an ordinary taxing statute a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated insofar as the particular item under consideration is concerned.

[54] Both the Vienna Convention and the Supreme Court of Canada in *Crown Forest* confirm that "literalism has no role to play in the interpretation of treaties": *Coblentz v. The Queen*, 96 DTC 6531 (FCA).

[55] In *Crown Forest* the Supreme Court of Canada also held that, in ascertaining the purposes of a treaty article, a court may refer to extrinsic materials which form part of the legal context, including model conventions and official commentaries thereon, without the need to first find an ambiguity before turning to such materials.

[56] The Preamble to the US Treaty sets out its purposes of reducing or eliminating double taxation of income earned by a resident of one country from sources in the other country, and of preventing tax avoidance or evasion. In *Crown Forest* the Supreme Court of Canada held that the purposes of the US Treaty also included the promotion of international trade between the two countries and the mitigation of administrative complexities arising from having to comply with two uncoordinated taxation systems.

[57] In *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54, 2005 DTC 5523, the Supreme Court of Canada emphasized that "[t]he provisions of the *Income Tax Act* must be interpreted in order to achieve consistency, predictability and fairness so that taxpayers may manage their affairs intelligently." This Court sees no reason why the objectives of consistency, predictability and fairness should be any less in the case of the interpretation and application of international tax conventions forming part of applicable Canadian income tax law.

[58] On the substantive issue of the meaning of the phrases resident of a contracting state and liable to tax by reason of the enumerated criteria, the Supreme Court of Canada in *Crown Forest* clearly concluded that the definition sought to describe those who are subject to as comprehensive a tax liability as is imposed by a state, which in the US as in Canada is taxation on worldwide income. The Court was not faced in *Crown Forest* with circumstances where one person's worldwide income was subject to tax in the hands of another related entity resident in the same jurisdiction by virtue of specific US domestic taxing rules. It is nonetheless a strong confirmation that the intended purpose and scope of Articles I and IV of the US

Treaty were that the treaty apply to those bearing full tax liability in either of the contracting states based upon the nature and extent of their connections with that country.

[59] In *The Queen v. Prévost Car Inc.*, 2009 FCA 57, 2009 DTC 5053, the Federal Court of Appeal wrote:

> 10 The worldwide recognition of the provisions of the Model Convention and their incorporation into a majority of bilateral conventions have made the Commentaries on the provisions of the OECD Model a widely-accepted guide to the interpretation and application of the provisions of existing bilateral conventions (see *Crown Forest Industries Ltd. v. Canada*, [1995] 2 S.C.R. 802; Klaus Vogel, "*Klaus Vogel on Double Taxation Conventions*" 3rd ed. (The Hague: Kluwer Law International, 1997) at 43. In the case at bar, Article 10(2) of the Tax Treaty is mirrored on Article 10(2) of the Model Convention.
>
> 11 The same may be said with respect to later commentaries, when they represent a fair interpretation of the words of the Model Convention and do not conflict with Commentaries in existence at the time a specific treaty was entered and when, of course, neither treaty partner has registered an objection to the new Commentaries. For example, in the introduction to the Income and Capital Model Convention and Commentary (2003), the OECD invites its members to interpret their bilateral treaties in accordance with the Commentaries "as modified from time to time" (par. 3) and "in the spirit of the revised Commentaries" (par. 33). The Introduction goes on, at par. 35, to note that changes to the Commentaries are not relevant "where the provisions… are different in substance from the amended Articles" and, at par. 36, that "many amendments are intended to simply clarify, not change, the meaning of the Articles or the Commentaries".

D. *OECD Model Treaty*

[60] Articles 1 and 4 of the OECD Model Treaty correspond to Articles I and IV of the US Treaty.

[61] The language used in Article I of the US Treaty and Article 1 of the OECD Model Treaty differ in that the US Treaty provides that the treaty is "generally applicable" to residents of a contracting state whereas the OECD Model Treaty uses the word "applicable". The use of the phrase "generally applicable" in the US Treaty suggests that the US Treaty may also be applicable to others in particular circumstances. Indeed, this is confirmed in the original Technical Explanation to the US Treaty.

[62] The OECD Commentary on Article 1 has more than three pages of commentary on the application of the OECD Model Treaty to partnerships. The commentary on partnerships is instructive in interpreting the phrase "liable to tax" in a contracting state because neither the OECD Model Treaty nor, in the years in question, the US Treaty expressly provided how they applied to partnerships and partners. Of specific interest are paragraphs 4, 5 and 6.3 of the OECD Commentary on Article 1 which read as follows:

> 4. A first difficulty is the extent to which a partnership is entitled as such to the benefits of the provisions of the Convention. Under Article 1, only persons who are residents of the Contracting States are entitled to the benefits of the tax Convention entered into by these States. While paragraph 2 of the Commentary on Article 3 explains why a partnership constitutes a person, a partnership does not necessarily qualify as a resident of a Contracting State under Article 4.
>
> 5. Where a partnership is treated as a company or taxed in the same way, it is a resident of the Contracting State that taxes the partnership on the grounds mentioned in paragraph 1 of Article 4 and, therefore, it is entitled to the benefits of the Convention. Where, however, a partnership is treated as fiscally transparent in a State, the partnership is not "liable to tax" in that State within the meaning of paragraph 1 of Article 4, and so cannot be a resident thereof for purposes of the Convention. In such a case, the application of the Convention to the partnership as such would be refused, unless a special rule covering partnerships were provided for in the Convention. Where the application of the Convention is so refused, the partners should be entitled, with respect to their share of the income of the partnership, to the benefits provided by the Conventions entered into by the States of which they are residents to the extent that the partnership's income is allocated to them for the purposes of taxation in their State of residence (cf. paragraph 8.7 of the Commentary on Article 4).
>
> . . .
>
> 6.3 The results described in the preceding paragraph should obtain even if, as a matter of the domestic law of the State of source, the partnership would not be regarded as transparent for tax purposes but as a separate taxable entity to which the income would be attributed, provided that the partnership is not actually considered as a resident of the State of source. This conclusion is founded upon the principle that the State of source should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident. For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a

> special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States.[8]

[Emphasis added.]

[63] The OECD commentaries to Article 1 with respect to partnerships are expressly said to be the conclusions of the OECD Partnership Report.

[64] Two OECD countries expressly reserved on paragraphs 5 and 6 of the commentary on the basis that express language in a treaty would be required. A third country made a similar reservation in respect of all of the commentary to Article 1. Neither Canada nor the US reserved nor made an observation on this point.[9]

[65] The Working Group of the Committee on Fiscal Affairs which authored the OECD Partnership Report was formed to study the application of the OECD Model Treaty to partnerships, trusts and other non-corporate entities. While the OECD Partnership Report focuses on partnerships, the report opens with an acknowledgment that many of the principles discussed therein may also apply with respect to other non-corporate entities. The Court was not made aware of any OECD developments regarding other non-corporate entities. The Court agrees that many of the same principles and considerations also apply to a determination of whether the income of an LLC is entitled to treaty benefits.

[66] Paragraph 26 of the OECD Partnership Report provides that many of the difficulties resulting from some countries treating partnerships as taxable entities and others treating their income as flowed through to their partners may be solved through a better coordination in the application and interpretation of the tax conventions.

[67] Paragraph 27 provides:

> 27. Where income is derived from a particular State, the determination of the tax consequences in that State will first require the application of the domestic tax laws of that State. It is the provisions of these laws that will determine who may be subjected to tax on that income in that State. <u>The provisions of tax conventions, however, may then intervene to restrict or eliminate the taxing rights originating from domestic law where a person, usually but not necessarily the taxpayer</u>

[8] It appears that the reference in paragraph 6.3 to the “preceding paragraph” must contextually be a reference to paragraph 5 or should read “paragraphs”.

[9] One of the reserving countries was France; Canada had earlier amended its tax treaty with France to expressly recognize partnerships and other fiscally transparent entities.

identified under domestic law, is eligible for the benefits of the tax convention in relation to that income.

[Emphasis added.]

[68] Paragraph 34 provides:

> 34. . . . If the State in which a partnership has been organised treats that partnership as fiscally transparent, then the partnership is not "liable to tax" in that State within the meaning of Article 4, and so cannot be a resident for purposes of the Convention. Although inconvenient at times (e.g. paragraph 89 below), there appears to be little scope for a contrary argument under the current wording of Article 4.[10]

[69] Paragraph 47 provides:

> 47. Where the partnership as such does not qualify as a resident under the principles developed in the preceding section, the Committee agrees that the partners should be entitled to the benefits provided by the Conventions entered into by the countries of which they are residents to the extent that they are liable to tax on their share of the partnership income in those countries. The following introductory examples illustrate the results which the Committee believes are appropriate in some commonly recurring situations. It is important to note that the solutions developed in this report do not exclude the possibility that Member countries may in their bilateral relations develop different solutions to the problems of double taxation which may arise in connection with partnerships.

[Emphasis added.]

[70] The OECD Partnership Report goes on to then provide detailed examples in which it sets out the appropriate results for a number of commonly recurring situations. Example 4 deals with a situation where the country in which the income is sourced treats a partnership as a taxable entity and the other treats it as a fiscally transparent entity. While this is not the case for Canada as source country with respect to partnerships, it is the case for Canada as the source country with respect to US LLCs, and is to that extent instructive. Paragraphs 60 to 62 of the report provide:

> 60. Under [source] State S domestic law, the taxpayer will be partnership P. State S could then argue that since partnership P is not entitled to the benefits of the treaty, it can tax the income derived by P regardless of the provisions of the S-P Convention. This, however, would mean that the income on which A and B are

[10] See also paragraphs 40 and 43 of the report for further statements on fiscally transparent partnerships not being "liable to tax".

> liable to tax in State P would be subjected to tax in State S regardless of the Convention, a result that seems in direct conflict with the object and purpose of the Convention.
>
> 61. The Committee compared that approach, under which State S applies the provisions of the Convention by reference to the treatment of the partnership under its domestic law, with another approach, under which State S considers the entitlement to treaty benefits of A and B, both residents of State P, under the principles put forward above. Under the latter approach, State S would determine that the provisions of the Convention should be applied to prevent it from taxing the royalties since, under these principles, the income must be considered to be paid to A and B, two residents of State P, who should also be considered to be the beneficial owners of such income as these are the persons liable to tax on such income in State P. The Committee concluded that this approach was the correct one as it is more likely to ensure that the benefits of the Convention accrue to the persons who are liable to tax on the income.
>
> 62. The Committee did not consider this approach to be inconsistent with the provisions of paragraph 2 of Article 3, under which terms not defined in the Convention have, unless the context provides otherwise, the meaning which they have under the domestic law of the Contracting State that applies the Convention. In the example, the tax treatment of the partnership in State P is part of the facts on the basis of which the terms of the Convention are to be applied. Thus, by referring to that tax treatment, State S does not adopt a particular interpretation of the terms of the Convention put forward by State P; it merely takes into account of facts required for the application of these terms. The Committee concluded that, in any event, if an interpretation based on domestic law would lead to cases where the income taxed in the hands of residents of one State would not get the benefits of the Convention, a result that would be contrary to the object and purpose of the Convention, the context of the Convention would require a different interpretation.

[Emphasis added.]

[71] Article 4 of the OECD Model Treaty does not differ in any material respect from Article IV of the US Treaty with respect to the meaning of the term "resident of a Contracting State".

[72] The OECD Commentary to Article 4 makes it clear in paragraphs 8 and 8.5 that the concept of persons liable to tax by reason of the enumerated criteria is trying to capture those who are subject to comprehensive taxation, being a full liability to tax on all income wherever earned. This is consistent with the comments of the Supreme Court of Canada in *Crown Forest*.

[73] Paragraph 8.7 of the OECD Commentary to Article 4 provides:

> 8.7 Where a State disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State. In such a case, <u>since the income of the partnership "flows through" to the partners under the domestic law of that State, the partners are the persons who are liable to tax on that income and are thus the appropriate persons to claim the benefits of the conventions concluded by the States of which they are residents. This latter result will be achieved even if, under the domestic law of the State of source, the income is attributed to a partnership which is treated as a separate taxable entity.</u> For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States.

[Emphasis added.]

[74] Some countries did reserve on paragraph 8.7 but neither Canada nor the US reserved or made a relevant observation.

[75] From these OECD materials it seems clear that the OECD wants to be able to maintain that a partnership that is treated as a flow-through in its country of establishment will not be considered liable to tax therein for purposes of the OECD Model Treaty. However, the OECD makes it equally clear that, the OECD Model Treaty is intended to, and should be interpreted and applied in a manner that nonetheless extends the benefits of the Convention to the income of such a partnership notwithstanding that it is not, strictly speaking, a resident of its home country. In the case of partnerships this is to be done at the partner level notwithstanding that the partnership is not liable to tax in its home country and its partners are not considered to have earned the income in the source country.

[76] While these two conclusions — that a partnership is not liable to tax in its home country if it is treated as fiscally transparent and that its income from a source country that does not regard it as fiscally transparent should nonetheless get the benefit of the tax convention — are developed in the context of fiscally transparent entities that are partnerships, this Court sees no reason that the conclusions should be any different in the case of a fiscally transparent US LLC.

[77] Clearly these conclusions and the reasoning in the OECD Model Treaty and commentaries reflect the intention of the OECD member countries, including Canada and the US, with respect to treaties based upon the OECD Model Treaty, such as the US Treaty. Further, given the absence of reservations or observations thereon by

Canada and the US, the Court accepts that these reflect the intentions of Canada and the US with respect to the US Treaty specifically and how its objects and purposes are to be achieved.

E. *Canadian Interpretation and Administration*

[78] In *Crown Forest* the Supreme Court of Canada quoted with approval from the decision of the Supreme Court of the United States in *Sumitomo Shoji America, Inc. v. Avagliano et al.*, 457 U.S. 176 (1982), that "[a]lthough not conclusive, the meaning attributed to treaty provisions by the Government agencies charged with their negotiation and enforcement is entitled to great weight."

[79] In CRA Income Tax – Technical News No. 35 dated February 26, 2007, the CRA outlines its "long-standing position" on liability to tax for treaty purposes. In it the CRA wrote:

> It remains CRA's position that, to be considered "liable to tax" for the purposes of the residence article of Canada's tax treaties, a person must generally be subject to the most comprehensive form of taxation as exists in the relevant country. This, however, does not necessarily mean that a person must pay tax to a particular jurisdiction. There may be situations where a person's worldwide income is subject to a contracting state's full taxing jurisdiction but that state's domestic law does not levy tax on a person's taxable income or taxes it at low rates. In these cases, the CRA will generally accept that the person is a resident of the other Contracting State unless the arrangement is abusive. . .

[80] It is not disputed that the CRA has a long-standing practice of characterizing the income earned by a foreign partnership made up of foreign partners consistent with the OECD Partnership Report. That is, even though the partnership is a fiscally transparent entity, the partners of the partnership will be entitled to treaty benefits. With respect to the US Treaty, the CRA has acknowledged this is based upon its understanding of the intent of Canada and the US.[11]

[81] The CRA has also confirmed that it will treat a so-called "S Corporation" as a resident of the US for purposes of the US Treaty.[12] A US corporation that elects under subchapter S of the US Code is treated as a flow-through entity whose income

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[11] See, for example, CRA Document No. 2000-0028475 "Withholding Tax-Partnership" dated August 21, 2001; CRA Document No. 2004-0074241E5 "212(13.1)(*b*) and ITAR 10(6)" dated July 19, 2005; CRA Document No. 2001-0085693 "Refinancing of Cansub" dated September 12, 2001 (wherein the US partnership elected corporate treatment); and CRA Document No. 9713120 "LLC — Status for Canada-US Income Tax Treaty" dated May 20, 1997.

[12] See, for example, CRA Document No. 9511425 "Residence of a US 'S' Corporation" dated October 31, 1995.

is taxed under the US Code in the hands of its shareholders. This was again confirmed by the CRA in a 2008 Technical Interpretation[13] without mention of new paragraphs 6 and 7 of the Article IV added by the Fifth Protocol Amendments.

[82] However, in the case of LLCs, the CRA appears to have departed from the above consistency. In a 1993 Technical Interpretation[14] the CRA first addresses the need to determine whether a particular US state's LLCs should be considered corporations or partnerships based upon their particular characteristics.[15] The CRA went on to say that, if an LLC is treated as a partnership for purposes of the US Code such that the partners rather than the company are liable to tax on the company's income, the LLC will not be considered a resident of the US for purposes of the US Treaty. It does not expressly deal with whether or why members of the LLC will or will not enjoy treaty benefits on the same basis as partners of a partnership. In its later May 20, 1997 interpretation[16] the CRA identifies its concern as being that, if a US LLC enjoys US Treaty benefits, a Canadian resident could carry on its Canadian business in Canada through a US LLC and avoid both Canadian and US taxes on the income of its Canadian business.[17]

[83] In Income Tax – Technical News No. 16 dated March 8, 1999 the CRA confirmed its positions that S Corporations will be treated as treaty residents and that LLCs will not. It noted the inconsistency and regretted, but did not reverse, its S Corporation position. It did not acknowledge, address or attempt to reconcile its treatment of LLCs with its treatment of partnerships nor did it address specifically the members of an LLC.

[84] From the above it can be seen that Canadian tax authorities have, with the sole exception of their approach to LLCs, been consistent in their interpretation and application of the US Treaty provisions applicable to a determination of treaty residence. They extended treaty benefits to US not-for-profit organizations and pension funds notwithstanding that these entities did not generally pay tax under the US Code. They similarly extended treaty benefits to government entities notwithstanding that they were not liable to tax under the US Code. They extended treaty benefits to S Corporations notwithstanding that their income is flowed through to their shareholders under the US Code. They extended treaty benefits to the income

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[13] Interpretation No. 2005-0144621E5 "Qualified Subchapter S Subsidiary" dated January 28, 2008.
[14] CRA Document No. 9234262 "Status of US Limited Liability Company" dated June 22, 1993.
[15] This is similar to the issue recently before the United Kingdom's First-tier Tribunal (Tax) in *Swift v. Her Majesty's Revenue & Customs*, [2010] UKFTT 88 (TC).
[16] *Supra*, footnote 11.
[17] Presumably only if it did not have a Canadian PE.

of foreign partnerships notwithstanding that their income is flowed through to partners, such treaty benefits to be determined and enjoyed at the partner level.

[85] The sole anomaly is the CRA's position with respect to US LLCs which, even after the lengthy trial herein, remains largely unexplained and entirely irreconcilable with the Canadian government's approach to foreign partnerships.

[86] The treatment of partnerships and of LLCs should be analagous for purposes of the interpretation and application of the US Treaty. A non-Canadian partnership is deemed to be a person with respect to payments made to it for Part XIII non-resident withholding tax purposes: see paragraph 212(13.1)(*b*) of the Canadian Act. A US LLC such as TD LLC is treated as a corporation and thus a separate person for purposes of the Canadian Act. In each case the partnership and the LLC are the taxpayers for purposes of the Canadian Act. In neither case are the partners or members the taxpayers. In the years in question the US Treaty did not have an express rule for partnerships or for LLCs or other fiscally transparent entities. The CRA applies a look-through approach in applying Canadian tax treaties to partnerships, even though the taxpayer for Part XIII Canadian non-resident withholding tax purposes is the partnership, not the partners.[18]

[87] This Court concludes, from the overwhelming consistency of the Canadian government's approach to fiscally transparent entities and to other entities that are not liable to tax under a treaty partner's domestic legislation, that it was not intended that an entity whose income was fully and comprehensively taxed in the other contracting state would be denied the benefit of a treaty simply because its income was taxed by the other country at the level of its shareholders, members or partners.

[88] Further, implicit in the CRA's position with respect to partnerships and S Corporations is that the basis of taxation of an owner (partner or shareholder) is a similar criterion to the enumerated criteria for purposes of Article IV of the US Treaty. Similarly, paragraph 6.2 of the *Income Tax Conventions Interpretation Act* also makes it clear that, in considering whether a partnership is a resident of another state for purposes of a tax treaty, the residence of the partners is relevant. This is also implicit in the CRA's administrative positions described above as well as in the OECD Commentary and Partnership Report.

[18] Oddly, in argument the respondent acknowledged several times that the CRA appeared to be wrong in law in so extending treaty benefits to partnerships although it made sense to do so administratively.

F. *US Interpretation and Administration*

[89] The interpretation and administration of the provisions of a treaty by a treaty partner can also be instructive and provide evidence of the intentions, objects and purposes of the treaty. All of the US material before the Court confirms that the approach of the US authorities to the interpretation and application of tax treaties to fiscally transparent entities is consistent with the OECD look-through approach.

[90] The Chief Counsel of the US Treasury issued a Technical Assistance dated March 15, 2000 on the subject of Certification of Limited Liability Companies. It addressed the issues of whether and how the IRS should respond when requested to certify to a treaty partner country's tax authorities that a single-owner LLC is a resident of the US that is entitled to treaty benefits under the US tax convention. The Chief Counsel's conclusion is:

> Because a single-owner LLC that is disregarded as an entity separate from its owner is not a "person", nor is it "liable to tax", the [IRS] may not certify that the LLC is a resident of the United States. However, the [IRS] may certify that the single-owner of the LLC is a resident of the United States, which should suffice to establish that income derived by the LLC in the treaty country is being derived by a resident of the United States and is entitled to treaty benefits.

[91] The US competent authority has also determined under the mutual agreement procedures with several of its other treaty partners that the income of LLCs will be extended treaty benefits at the member level on a look-through basis.[19] The United Kingdom revenue authority had also confirmed this approach to US LLCs in its Double Taxation Relief Manual prior to being "formalised" by amendments to the US-UK Treaty.[20]

[92] The Associate International Tax Counsel of the US Department of the Treasury addressed the 1994 Annual Conference of the Canadian Tax Foundation as part of a panel on Canada-US Cross-Border Issues. According to the published summary, in discussing the Third Protocol Amendments to Article IV of the US Treaty dealing with government entities, not-for-profit organizations and pension funds, the US attached no significance to the failure of the Protocol to deal specifically with the treatment of partnerships and confirmed that the existence of a partnership will not preclude the availability of treaty benefits. "The US authorities generally apply a look-through approach to analysing partnerships in the treaty

[19] Mexico, Spain and New Zealand.
[20] DT1985 3A United States Limited Liability Companies. This confirmed the UK authority's earlier position set out in Inland Revenue Tax Bulletin, Issue 29, dated June 1997.

context: treaty benefits are granted to the extent that the partners themselves qualify for such benefits." It is noted that the Canadian Assistant Deputy Minister of Finance responsible for the Tax Policy Branch — the very group responsible for the negotiation of Canada's tax treaties including the US Treaty and the Protocols thereto — was on the same panel and did not express a different view. Indeed, the rapporteurs note by way of footnote that the CRA has expressed the same view in the technical interpretations going back to 1983.

[93] Treasury Regulations under section 894 of the US Code provide that the US will only extend treaty benefits to passive income derived by a treaty resident of another country through a fiscally transparent entity if the income is taxed by the other country on the same basis as to timing, character and source as had the treaty resident earned the income directly.[21] Treasury Decision 8722 which announced the Temporary Regulations makes it clear that it is well established that, in interpreting and applying US tax treaties, fiscally transparent entities are ignored and a look-through approach is intended, with the result that the entity's owners are treated as the persons who derive the income. Treasury Decision 8889 of 2000 which announced the Final Regulations confirms that the US regards the principles behind Treasury Regulations 894 as fully consistent with its treaties. These comments in these last two documents are not limited to passive income.

[94] The *United States Model Income Tax Convention* of 2006 (the "US Model Treaty") provides expressly in Article 1 that income derived through an entity that is fiscally transparent under the laws of either contracting states shall be considered to be derived by a resident of a state to the extent that the item is treated for purposes of the taxation law of such contracting state as the income of a resident. The Technical Explanation to the US Model Treaty confirms expressly that this would apply in the case of an LLC. While the US Model Treaty is simply that, a model treaty, the Technical Explanation to it provides that the intention of the rule is to "eliminate" certain "technical problems" that "arguably" would have prevented persons investing through a fiscally transparent entity from claiming treaty benefits. The predecessor US Model Treaty of 1996 was to a similar effect.

[95] It is clear from the above that the US has throughout intended that the entitlement to treaty benefits of income earned by a fiscally transparent entity such as a partnership or LLC be determined at the member level using a look-through approach and that the US has consistently interpreted Article IV of the US Treaty to permit or require that approach.

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[21] These are expanded upon in US Revenue Rulings 2000 59 and 2000 2 CB593.

IV. Conclusion

[96] The US Code comprehensively taxes the worldwide income of TD LLC as fully as if it had been earned by any other entity including a US domestic corporation. The only problem arises because it is not TD LLC that is taxed on the income. The US Code provides that the income of TD LLC is fully and comprehensively taxed to its member, Holdings II. This income is consolidated in the TD USA tax return and tax thereon is charged back by TD USA to TD LLC.

[97] In such a case, it seems clear that the income of TD LLC should enjoy the benefits of the US Treaty. The evidence is overwhelming that the object and purpose of the US Treaty read in the context of all of the evidence and authorities would not be achieved and would be frustrated if the Canadian-sourced income of TD LLC that is fully taxed in the US under the US Code does not enjoy the benefits of the US Treaty including Article X(6). The appeal must therefore be allowed and the assessments be sent back to the Minister for reconsideration and reassessment on the basis that the Canadian branch profits of TD LLC enjoy the favourable reduced Part XIV branch tax rate reduction provided for in Article X(6) of the US Treaty.

[98] Canada gets to choose who to tax under the Canadian Act, a US LLC or its members, a partnership or its partners. However, when deciding how to apply its international convention with its treaty partner, Canada must consider as part of the context that the US also gets to choose at which level to impose its domestic tax under the US Code on that income, partnership or partner, LLC or member. This was clearly intended by the treaty countries in order to give effect to the US Treaty's object and purpose. It makes little sense to think that treaty entitlement should be affected by a US LLC's exercise of its right under the US Code to elect to have its income taxed in its hands or flowed through and taxed in the hands of its US resident members.

[99] The proper method of interpreting the US Treaty to determine if it applies to income earned by to US partnerships that are fiscally transparent and by US LLCs including TD LLC prior to the Fifth Protocol Amendments, is to follow the interpretive approach taken by the OECD countries, the OECD Model Treaty and the related commentaries and report. That is, to read the text of the opening sentence of Article IV in the context of the treaty as a whole, in the context of the object and purpose of the treaty, and in the context of how our treaty partner chooses to fully and comprehensively impose tax under its domestic tax legislation, the US Code, on

the income of TD LLC and other fiscally transparent entities. This is consistent with the approach taken by Canada and the US with respect to the interpretation of the US Treaty in its application to government entities and not-for-profit organizations prior to the addition of specific amendments confirming the treaty's application to such entities. It is also consistent with both countries' approach to determine the treaty entitlements of non-corporate entities such as partnerships and S Corporations prior to the Fifth Protocol Amendments. The result also harmonizes with section 219.2 which does not require that a treaty's reduced withholding tax rate apply to the particular taxpayer. The result does not jeopardize the Canadian approach to partnerships under all Canadian tax treaties but for the US and France treaties where we now have express language. Such an approach is also entirely consistent with the approach Canada and the US have taken in respect of the application of the US Treaty in later years under the Fifth Protocol Amendments, the terms of which textually do not provide that partnerships, LLCs and other fiscally transparent entities are deemed to be residents for purposes of Article IV; the treaty partners instead chose to rely upon the Technical Explanation to impose the obligation on the tax administrators of each country to ensure that treaty benefits would nonetheless be enjoyed on the income earned in or from the other country by a partnership, LLC or other fiscally transparent entity.

[100] Such an approach dictates the simple conclusion that the relevant articles of the US Treaty be interpreted in such a manner that the Article X(6) branch profits tax rate reduction applies to the Canadian branch profits of TD LLC. That is sufficient to dispose of this appeal and is a tempting place to conclude. However, there are certain further conclusions which can and must be drawn from this as a matter of logic and reason as well as law.

[101] The OECD Commentaries on this issue are clear from a substantive point of view but appear to be walking a fine semantic line. On more than one occasion they state in a principled fashion that the fiscally transparent entity is not liable to tax. However, each time they go on to conclude in a pragmatic fashion that, interpreted and applied correctly having regard to the treaty's intended object and purpose, treaty benefits should apply to the income of the entity based on the member's entitlement. The commentaries then go on to say that the relief can nonetheless be delivered at the entity level. The OECD Commentary may have a good reason for not wanting to conclude one way or the other on whether the treaty so applies because the entity is resident for treaty purposes or because the income is that of the member for treaty purposes. Given the vastly different legal and tax régimes represented by the OECD, this Court cannot guess what the motivating reasons for this diplomatic ambiguity are and no representative of Canada testified at this trial. However, this Court finds it

easier to discern how Canada and the US can be presumed to have the US Treaty so apply given that they subsequently addressed the issue in the Fifth Protocol Amendments and the Technical Explanation thereto. While Canada and the US try to walk both lines — in the treaty text not treating the entity as a resident because it is not liable to tax yet acknowledging their intention of applying the text as if the LLC was a resident —, having forced this matter to court, Canada can perhaps no longer leave it ambiguous. Since this Court has to decide whether TD LLC is a resident of the United States and liable to tax therein by reason of one of the enumerated or similar grounds, it concludes that it is. The Court concludes that implicit in the clear intention of the OECD countries, including Canada and the US, that treaty benefits be enjoyed by TD LLC in the present circumstances, and given the context of the Canadian and US tax régimes and the text of the US Treaty :

(i) TD LLC must be considered to be a resident of the US for purposes of the US Treaty otherwise the treaty could not apply;

(ii) TD LLC must be considered to be liable to tax in the US by virtue of all of its income being fully and comprehensively taxed under the US Code albeit at the member level; and

(iii) the income of TD LLC must be considered to be subject to full and comprehensive taxation under the US Code by reason of a criterion similar in nature to the enumerated grounds in Article IV, namely the place of incorporation of its member which is the very reason that TD LLC's income is subject to full taxation in the US.

V. <u>The Respondent's Concerns of Potential Abuse</u>

[102] The respondent argued that, if this appeal is allowed, there would be potential abuse and ambiguity of application of the US Treaty to US LLCs on a going forward basis subsequent to the Fifth Protocol Amendments. The expressed concern is that, if this appeal is allowed, US LLCs and partnerships that are fiscally transparent will be able to choose in the future between having the US Treaty apply in accordance with the reasons herein or, alternatively, in reliance upon new paragraph 6 of Article IV. Potential abuse and frustration of the purpose of the Fifth Protocol Amendments would result since the application of the reasons in this case would not incorporate the requirements of paragraph 7 of Article IV added by the Fifth Protocol Amendments.

[103] The respondent's expressed concerns are not persuasive. The revised US Treaty, including the Fifth Protocol Amendments thereto, will be both part of the text and context to be considered when applying the US Treaty in any such future case. It cannot reasonably be expected that the amended and revised US Treaty would necessarily be interpreted and applied in a manner similar to how it was interpreted in the context of its provisions prior to the specific amendments dealing with partnerships, LLCs and other fiscally transparent entities.

[104] The Court recognizes a certain irony in the fact that its decision in this case has been, on a prospective basis, statutorily overridden prior to it having been decided. Further, this decision cannot be said to stand for the simple proposition that every US LLC is a resident of the US for the purposes of the US Treaty. On the facts of this case, as put before this Court, and the applicable law and authorities advanced and argued by the parties, the requirements of new paragraphs 6 and 7 of Article IV would be satisfied by TD LLC and Holdings II if the Fifth Protocol Amendments were applicable to the years in question. For that reason the decision in this case does not constitute a materially different gate to access the US Treaty by US LLCs, much less a potential flood gate.

[105] In this case, the respondent did not even suggest that there was any potential avoidance of Canadian taxes or abuse of the Canadian tax régime resulting from the decision by the TD Bank group to use a US LLC to operate a Canadian branch. There were clearly understandable and unchallenged business purposes, including non-abusive state tax planning purposes, to operate its US broker-dealer business as a US LLC and for that business to establish a Canadian branch. If, in another case, prior to or following the Fifth Protocol Amendments, the respondent takes the position that the use of a US LLC in that case contributes to inappropriate or abusive tax avoidance, that will form part of the context to be considered by a court in its interpretation and application of the US Treaty in that case. The respondent does not even suggest in this case that TD LLC has been used in an abusive manner to access US Treaty benefits, nor to achieve any other tax abuse. Had potentially abusive tax avoidance or potential treaty abuse formed part of the context the Court had to consider in this case, the outcome may have been different. This is best left for a court to deal with in the future should it arise.

[106] Further, not only did this Court not have to address the express limitation provisions in new paragraphs 6 and 7 of the Article IV of the US Treaty, it was not asked to consider the potential application of any other limitation of benefits provisions or principles applicable to the treaty, nor to consider the possible application of the section 245 general anti-avoidance rule to the facts of this case.

Had any of these been put forward as even potentially applicable, which the respondent properly did not, the context of this case would have further changed.

[107] The decision in this case stands for no more than the proposition that, properly interpreted and applied in context in a manner to achieve its intended object and purpose, the US Treaty's favourable tax rate reductions apply for years prior to the Fifth Protocol Amendments to the Canadian-sourced income of a US LLC if all of that income is fully and comprehensively taxed by the US to the members of the LLC resident in the US on the same basis as had the income been earned directly by those members.

VI. Disposition

[108] The appeal is allowed and the assessments are sent back to the Minister of National Revenue for reconsideration and reassessment in accordance with these reasons.

[109] The appellant is entitled to costs, including the reasonable costs incurred for its expert report and the testimony of its expert.

Signed at Toronto, Ontario, this 8th day of April 2010.

"Patrick Boyle"

Boyle J.

CITATION:	2010 TCC 186
COURT FILE NO.:	2008-2314(IT)G
STYLE OF CAUSE:	TD SECURITIES (USA) LLC v. HER MAJESTY THE QUEEN
PLACE OF HEARING:	Toronto, Ontario
DATES OF HEARING:	January 20, 21, 22 and February 2, 2010
REASONS FOR JUDGMENT BY:	The Honourable Justice Patrick Boyle
DATE OF JUDGMENT:	April 8, 2010

APPEARANCES:

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Counsel for the respondent:	Elizabeth Chasson H. Annette Evans Brandon Siegal

COUNSEL OF RECORD:

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