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Analysis of the Technical Explanation for the Fifth Protocol to the Canada-U.S. Income Tax Convention

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The much awaited Technical Explanation ("TE") of the Fifth Protocol to the Canada-United States Income Tax Convention (September 21, 2007) was presented with the Protocol to the Committee On Foreign Relations of the United States Senate on July 10.[1] This is an integral step in the ratification of the Protocol by the United States and its eventual entry into force. Canada ratified the Protocol on December 14, 2007.

Some Preliminaries

The release of the TE was preceded by the publication by the Staff of the U.S. Joint Committee On Taxation of its "Explanation" of the Protocol,[2] the comments in which were the subject of testimony before the Committee on Foreign Relations of the Deputy Chief of Staff of the Joint Committee, Ms. Emily McMahon.[3] Mr. Michael Mundaca, The Treasury Deputy Assistant

[1] Department of the Treasury Technical Explanation of the Protocol Done at Chelsea on September 21, 2007 Amending the Convention Between the United States of America and Canada With Respect to Taxes On Income and On Capital Done At Washington On September 26, 1980, As Amended by the Protocol Done On June 14, 1983, March 28, 1994, March 17, 1995 and July 29, 1993.

[2] Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada (Scheduled for a Hearing Before the Committee On Foreign Relations United States Senate On July 10, 2008 Prepared by the Staff of the Joint Committee On Taxation, July 8, 2008 JCX-57-8.

[3] Testimony of the Staff of the Joint Committee On Taxation Before the Senate Committee On Foreign Relations Hearing On the Proposed Protocol to the Income Tax Treaty With Canada and the Proposed Income Tax Treaty With Iceland and Bulgaria (JCX-60-08), July 10, 2008.

Secretary for International Tax Affairs, testified on behalf of the U.S. Department of the Treasury to present that Department's perspective on the Protocol and the TE.[4]

Contemporaneously with the release of the TE, which reflects the U.S.'s understanding of the Protocol, Canada expressed its formal concurrence in the TE. The Canadian Minister of Finance issued a release stating that "…Canada agrees that the TE accurately reflects understandings reached in the course of negotiations with respect to the interpretation and application of the various provisions in the Protocol." The Minister's release, otherwise entirely typical in this situation, is however particularly interesting in so far as both the Protocol and the TE necessarily adopt and incorporate by reference significant aspects of U.S. domestic tax law that do not have clear analogues or reference points in the Canadian tax system and are not otherwise given particular defined connotations in the Protocol itself. As an element of the context within which interpretative issues presented by the Protocol will be considered and resolved administratively or in judicial proceedings, there is little doubt that Canada's awareness of the U.S. law context and its apparent adoption of rules and principles that are not part of the Canadian tax system at least will have to be taken into account in interpreting and applying the Convention as modified by the Protocol. However, this somewhat unique accession to the tax regime of another country as the adopted Canadian tax framework is notable.

The Protocol modifies the Convention in a number of ways. There is a well informed general awareness of the terms of the Protocol and its Annexes that, among other things, explain how arbitration is to be available as part of the Mutual Agreement Procedure framed by the Convention. In this short article, we focus on some specific insights garnered from the TE which we think are particularly noteworthy and foreshadow the need for a heightened level of

[4] Testimony of Treasury Department Assistant Secretary for International Tax Affairs Michael F. Munhara Before the Senate Committee on Foreign Relations on Lending Income Tax Treaties, July 10, 2008 (hp-1076).

awareness and care for business taxpayers in the Canada-US axis. Our comments take into account the TE and the various official comments about it which we note above. In particular, we understand that the comments of the Joint Committee on Taxation are respected, in addition to the TE, in interpreting the Convention in the U.S. Based on prevailing Canadian law concerning the interpretation of tax treaties, all of the commentary that we have noted would at least be relevant, if not probative, in resolving interpretative uncertainty in the Convention and the Protocol where the terms of each, themselves and in their immediate context, could not resolve without recourse to relevant extrinsic materials of the sort contemplated by Articles 31 and 32 of the Vienna Convention On the Law of Treaties.

1. **“Services PEs”**

One of the most notable, but problematic, changes to the Convention effected by the Protocol is new Article V(9). The introduction of this “services” permanent establishment (“PE”) provision seemingly is a response to the Canadian *Dudney*[5] case in which a U.S. service provider present in Canada for approximately 300 days performing services continuously at the facilities of a Canadian client was found not to be carrying on business through a Canadian permanent establishment and accordingly not to be taxable by Canada.

This provision will, except in relation to building sites that do not satisfy the permanent establishment (“PE”) threshold in Article V(3), cause services providers of one State to have a PE in the other in two cases where the “enterprise” providing the service manifests the provision of those services in that State in a substantial way. The first case involves an individual on behalf of the enterprise being present in the host State for at least 183 days, where more than 50% of the enterprise’s “gross active business revenues” in that period are accounted for by these

[5] Dudney v. R., 2000 DTC 6169 (FCA); 99 DTC 147 (TCC).

services. The other involves the enterprise providing services for at least 183 days in the host State on the same or connected projects, regardless of how many people are involved or how much revenue is attributable to the performance of the services.

It is likely that Canada was the moving force behind the introduction of this provision, given its experience in the *Dudney* case. The U.S. negotiators, presumably, agreed to its inclusion as part of the usual treaty negotiation process. In an unusual move, the Joint Committee commented on issues that the Senate Foreign Relations Committee might, in its view, wish to consider further in its contemplation of the Protocol, and the Committee's hearing on July 10 included testimony and witness exchanges with the Senators highlighting a number of substantive and administrative concerns about this provision which have attracted attention in the business community. Mostly these concerns seem to relate to how, almost in a digital fashion, enterprises of one State and their employees could become taxable as an incident of the substantial ordinary cross border business and inter-corporate commercial intercourse that necessarily occurs in the very homogeneous North American business arena for which the Convention is an important framework. Evidently, according to the testimony of Mr. Mundaca, Canadian and U.S. tax officials are continuing to reflect on how this provision will be interpreted and administered.

A number of the concerns are quite basic, but nevertheless fundamental to the workability of this provision both in theory and practice. For example, the provision is based entirely on services being provided by an "enterprise of a Contracting State". Interestingly Canada and the U.S. abandoned the enterprise notion to establish tax jurisdiction, in favour of legal personality and residence, when the 1980 Convention replaced the former tax treaty between Canada and the U.S. One of the difficult interpretative aspects of the former treaty in this respect was the somewhat elusive and indefinite connotation of "enterprise", which could allow one State to

include in its tax base income attributable to activities conducted in the other based on an expansive view of this term. Indeed, this was the subject of judicial decisions, historically.[6] Neither "enterprise" nor "enterprise of a Contracting State" is defined in the Protocol. Since this will be the only place in the Convention in which these terms are used there is no internal context in the Convention to give them meaning. The TE sheds no light on what they mean or even that there may be an interpretative issue. This is perhaps not surprising, in so far as the TE is a U.S. document and the U.S. Model Tax Convention does adopt and define these terms in that context. Even so, however, when adopted in Model Tax Conventions – the Model Tax Convention of the Organisation of Economic Co-operation and Development uses these terms – they are defined and qualified in relation to a "resident of a Contracting State" and not the Contracting State itself.

This is not merely a semantic quibble. These terms are the bedrock of the provision itself. There are other interpretative conundrums. Among them is how a "gross revenue" test in the first, "key person", branch of the provision is meant to be understood and applied when it is expressed, confusingly, in terms of "income". The TE seems to treat the test as if it referred only to "gross revenue", in the manner of an equivalent test in the OECD's suggested text for a rule of this nature. Then, there is the differential use of "performed" and "present" versus "provided" in the two branches of the provision, raising the possibility of the taxation of income related to activities performed outside the host State with respect to the second branch of the test framed in terms of where services are "provided". In this area, the TE is helpful and in some respects reassuring, to conclude that only income that relates to services actually performed, "on the ground" as it were, in the host State are implicated. This is consistent with, though possibly not as clear as, the equivalent draft provision and related commentary offered by the OECD for

[6] For example, McMahon v. MNR, [1959] CTC 166 (Ex. Ct.).

countries, usually developing countries (as the TE notes), that may wish to adopt this additional protection of their tax bases against temporary or relatively insubstantial incursions by the enterprises of more robust developed countries.

The TE is particularly helpful in another area, of common concern to most multinationals whose day-to-day operations, certainly in North America, reflect a high degree of integration and shared services. The TE says that the affected services provided by an "enterprise" are only those provided to third parties and not internally to "that enterprise". The significance of what "enterprise" means, and whether in this usage it refers to all members of a corporate group and not merely to the particular member providing the services, is evident. One would think that the sensible interpretation is the former, that is that services provided by one member of a group to another that are internal and not directed to third parties – customers, suppliers and the like, and which occur as a fluctuating reality of international business, would not give rise to a PE in the host State. Indeed, it would be odd relief that was conditioned on the obvious realization that one cannot provide services to oneself, except possibly as a "dealing" to be recognized in attributing profits to a PE under Article VII as modified by the Protocol. Helpfully, the TE is consistent with the conclusion that inter-company services not part of a delivery of services to third parties are not the target, and the Joint Committee Explanation, in using the phrase "inter-company services" seems to adopt the this view. This is also consistent with the sense, if not the entirety or precisely the terms, of the OECD's draft commentary (in particular in paragraph 42.30 of that draft commentary released by the OECD on April 21, 2008.

2. <u>Attribution of Profits to PEs</u>

One of the most noteworthy modifications to the Convention arising from the Protocol is the adoption of the OECD's Transfer Pricing Guidelines to inform the attribution of income to a PE

and, in that connection, specifically the allocation of capital to it for taxpayers that are financial institutions. This very far reaching change is found in a comparatively modest comment in Annex B to the Protocol.

Article VII of the Convention, like most tax treaties, adopts the fiction of a branch, or a PE, as a separate entity, and the further fiction that implicit transfers of property and services to and from this fictional entity, and its capitalization, are to be assimilated to transactions and other characteristics that would take place if the "home office" and the "branch" were separate legal entities with separate financial accounts. The fiction, and its implication for expenses, are framed by Articles VII(1), (2) and (3) of the Convention. Clearly an important objective is to subject the determination of taxable income attributable to a branch to the same review as underlies the "Related Persons", or more casually "transfer pricing", Article IX.

This, of course, is a much easier objective to describe and than to achieve. It has been the subject of substantial consultation at the OECD, leading most recently to the publication of a report on the Attribution of Profits to Permanent Establishments that, among other things, adopts the OECD's Transfer Pricing Guidelines as a primary guide to or determinant of attributed PE profit. This has become know as the "AOA" (the "Authorized OECD Approach"). The report has only recently been finalized in its entirely and approved by the OECD's Committee on Fiscal Affairs at its June 24-25, 2008 meeting and the OECD Council at its July 17 meeting.[7] It appears, however, that the AOA or some approximation of it has in fact been adopted in one of

[7] OECD Release, July 7, 2008. At that meeting the Committee also approved the first stage version of the Commentary to Article 7 of the Model Tax Convention intended to adopt those aspects of the report considered to be consistent with the existing Article 7 of the Model. The OECD Council approved this on July 17, 2008. Also on July 7, the OECD released for comment a full scale reconstitution of Article 7 reflecting the report's conclusions, together with more far reaching consequential changes to the Commentary. These changes, if adopted, would much more firmly entrench in the Model an economic, transfer pricing based approach to measuring and attributing permanent establishment profit, essentially to reflect the AOA.

the most significant and complex tax treaties in the world, not without some precedent, however, in some other U.S. treaties.

Possibly the most problematic aspect of this analysis is the identification and measurement of fictional or synthetic transfers, or "dealings" in the OECD's terminology, as if they were actual contractual transactions between distinct legal personalities. There are various aspects to this concern. In principle, it is not clear that a dealing can, should or does give rise to the same kind of profit making transaction that would take place between related but distinct entities. For example, is the use of machinery or intellectual property in a simulated user arrangement such as a lease or licence meant to give rise to more than a cost allocation and indeed to profit for the constructive owner of the property?[8] There is some experience with this in Canada, in the *Cudd Pressure Control*[9] case. There the Canadian Courts declined to assimilate the use of machinery in relation to a permanent establishment in Canada as a lease by the "permanent establishment" from the "home office", and favoured, in the circumstances of that case and based on how the arrangements had been accounted for under financial accounting standards, a finding of constructive ownership of the machinery by the permanent establishment. However, a dissent in the Federal Court of Appeal decision left the door open to synthetic or notional constructions of arrangements between a "head office" and a "branch" comporting with user arrangements in the nature of a lease or licence. The U.S. has its own experience with whether actual, as accounted for in books of account, rather than notional, as provided in tax legislation, arrangements should determine the computation of attributed income in a treaty context. In the celebrated series of

[8] For example the OECD's Report on the Attribution of Profits to Permanent Establishments touches on this in various places, both in terms of the nature of "dealings" and the recognition of expenses under Article 7(3) of the Model Tax Convention (for example in Part I, paragraphs 13, 53, 54, 210, 211, 213, 217, 255, and 290). Also interesting in this context are new paragraphs 25, 27, 30, and 36 of the revised Commentary to Article 7 of the Convention.

[9] Cudd Pressure Control v. R., 98 DTC 6630 (FCA); 95 DTC 559 (TCC).

NatWest[10] decisions the U.S. courts have favoured the measurement standards ground in actual transactions, or at least the actual financial accounting capital and expense allocation, rather than those that would apply based upon legislated notional standards. In this connection, section 218.2 of the Canadian *Income Tax Act* contemplates the imposition of withholding tax on notional Canadian bank branch interest but only if Canada and a treaty partner have parallel rules applicable in equivalent circumstances. This and certain other provisions of the Act[11], however, manifests a latent tolerance in the *Act* for notional expenses being recognized with the same status as "real" expenditures of the same inherent quality. In the immediate context, "dealings" are to be recognized only for purposes of attributing profit to a permanent establishment and not for any other provision of the Convention, for example dealing with withholding tax, which apply to actual payments; the TE is clear in this point. Even so, however, questions may remain about whether notional expenses recognized for purposes of attributing profit to a permanent establishment necessarily will result in a deductible expense under the relevant State's tax legislation. The OECD anticipates this possibility in its first stage revised Commentary to Article 7 and 24 of the Model Tax Convention and in the attribution of profits report recently adopted by the OECD (See note 7, above, and the related comments in this Article.). It would seem that the transfer pricing guidelines, including the assimilation of dealings to actual legal arrangements, are meant to be applied to attribute economic profit to a permanent establishment but it remains to be determined under a State's tax law whether "dealing expenses" will be recognized for purposes of computing taxable income. Accordingly there is a possibility that a

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10 National Westminster Bank v. The United States, 512 F. 3d 1347. This is the most recent decision of several in relation to this taxpayer. A recent article that considers the entirety of the litigation in this case is Richard L. Reinhold and Catherine A. Harrington, "What NatWest Tells Us About Treaty Interpretation", Tax Notes International, June 16, 2008, p. 923; 50 Tax Notes International 923 (June 16, 2008).

11 Subsection 10(13) of the Canadian *Income Tax Act*, establishing a notional fair market value cost of property appropriated to a non-resident's Canadian inventory.

mutual agreement proceeding could be required to resolve double taxation where a credit for foreign tax is not available to resolve a resulting imbalance in taxation.

Another important question that pervades the international discussion in this area is whether notional expenses arising from notional transactions or dealings are deductible in computing branch income as they would be if arising from a separate contractual arrangement (subject to the usual standards of reasonableness and any particular statutory limitations).[12] Article VII (3) of the Convention and its analogue in the OECD Model Tax Convention limit the recognition of expenses to those that would be allowed under the State for which the income computation is relevant. There has been much debate as to whether, in the circumstances, this should be read as a limitation referable to the quality of the expenditures, i.e., whether the expenditure, synthesized as it must be as an expense of a notional entity to accomplish what Article VII requires, is of a character that would be acceptable as a deduction under relevant law if made by a separate legal entity, or is more restrictive and speaks to a limitation because the expenditure is notional calculation rather than a "real" expense, i.e., whether the only expenses that can be recognized are those that are actually incurred in relation to third party dealings of the taxpayer as a whole and, in accordance with functional and risk apportionment standards of the Transfer Pricing Guidelines, are rateably allocated in relation to the branch income computation. In Canada's case a further complicating, and possibly limiting, factor is the supervening implication of paragraph 4(b) of the *Income Tax Conventions Interpretation Act* ("ITCIA") which despite the terms of any treaty applies the kind of limitation in Article VII(3) as a matter of Canadian domestic law in relation to the application of treaties. In this connection, the specific observation in the TE that Article VII(3) does not allow a deduction for something that "by reason of its nature" is not deductible suggests that expenses are to be evaluated based on their inherent

[12] See note 8, above.

quality rather than whether, as conceived for a PE income computation they exist as "real" stand alone costs. However neither international opinion nor the TE incontrovertibly relieves doubt about this important point.

It seems that the TE is mostly helpful with respect to questions of this kind, and that the Joint Committee's comments are similarly positive directionally. In this particular area, the wholesale adoption, even of interpolated U.S. domestic law components, by Canada of the TE is important, generally and possibly as a response to any prospect of paragraph 4(b) of the *ITCIA* disrupting the order sought to be achieved by the Protocol. There is some confusion that persists from adopting the Transfer Pricing Guidelines (which are not entirely consistent with recognition being accorded to notional transactions or charges) on the one hand but otherwise favouring a seemingly generous endorsement of notional arrangements as devices to attribute income (but not for any other purpose or Article of the Convention (e.g. withholding tax), a specific qualification in the TE).

Even so however, it is not clear that some of the reservations about the tolerance of the arm's length standard for notional transactions, and in particular notional expenses, is not a current running deep in what otherwise may be intended to be still water. In this connection, the TE's willingness to entertain an election by a taxpayer to allocate capital to a PE based either on the arm's length standard or according to U.S. Treas. Reg. 1.882-5, in particular rather than regulatory risk-weighting for financial institutions which might otherwise apply and even be foreshadowed in Annex B to the Protocol, is very interesting. A capital allocation to a PE presumptively will be required, and as the TE notes a PE will not be allowed to be considered as being funded exclusively with debt. Three implications of this opportunity afforded taxpayers are notable. First, that the opportunity to adopt a more functional and qualitative approach to

measuring attributed capital and related dealings, ostensibly in line with the dictates of the arm's length standard, is significant. Second, however, what this means, here and more generally is perhaps clouded by the absence of any clear or incontrovertible direction on this point according to the arm's length standard. Third, Treas. Reg. 1.882-5 is not a part of or even close to replicating a provision of Canadian law yet, seemingly, given the adoption by Canada of the TE it or its equivalent has been imported at the election of taxpayers, if not by its terms by the probative weight given by Canadian law to extrinsic materials used to resolve treaty ambiguity. This, again, is not merely a quibble. The method by which profits are attributable to a permanent establishment is one of the most important but most difficult aspects of the Convention.

As a final but important observation on this aspect of the Protocol, it must be noted that the adoption of the Transfer Pricing Guidelines for Article VII has at least two other important ramifications beyond merely the computation of attributed PE income. In the OECD's report on profit attribution, these are noted as issues, but not resolved.[13] The constructive adoption of the AOA in the Convention may accelerate the need to come to ground on these issues. The first is whether the sharing or transfer of risks and functions within a corporate group, for example in a business restructuring that results in a less robust business presence of a subsidiary in a host State, gives rise, derivatively, to a PE and possibly a dependent agent (Article V(5)) PE in the host State of a group member that has or has succeeded to a shared function allowing for income that originates economically in the host State. The adoption of functional and risk assessment standards used for transfer pricing, for which this is a very live and a very controversial issue particularly in so far as "intangibles" are concerned, in the measurement of attributed PE income may make this issue difficult to ignore as a practical matter. The second concerns the inherent imprecision of the transfer pricing rules and guidelines, which mostly can justify a result within a

[13] Report on the Attribution of Profits to Permanent Establishments, Preface, paragraph 9 and Part I, paragraph 6.

range of results and depend on a common characterization of the affected transfers among taxpayers and interested tax authorities. Necessarily the factual and legal classification and qualification considerations will affect whether a residence State is obligated under the Convention to provide foreign tax credit for host, or source, State tax, in short whether the residence State must accept the source State's basis for measuring and computing the income and the resulting tax or whether it lies within its purview to refuse foreign tax credit because of a disagreement about how the Transfer Pricing Guidelines will have been applied by the source State to compute income (including selecting and applying a transfer pricing methodology) and indeed whether to recognize or characterize relevant transactions or transfers (including those that are notional but, necessarily under the Protocol, must and are meant to be considered) as the source State may perceive them. The OECD (which includes these treaty partners) has not resolved these questions, but they are not only theoretically but practically very important.

These changes also implicate some recent U.S. issues concerning the basis on which treaty benefits, generally, may be claimed. In recent U.S. Technical Interpretations relating to the Belgian treaty and the German protocol, the U.S. has expanded the application of its "consistency" or "anti cherry picking" rules.[14] The U.S. now views it necessary that the non-resident taxpayer choose the OECD Model Article Treaty PE attribution of income rules (in their entirety) or the rules of the IRC in their entirety. Thus, taxpayers claiming the benefits of a treaty may not be permitted to use the "trading for your own account IRC 864(b) rules). There are no similar comments in the current Canada-US TE so the result is unclear.

[14] See letter from Lawrence Uhlick of the Institute of International Bankers – October 1, 2007, as reported in Tax Analysts, October 1, 2007.

3. Binding Arbitration ("BA")

In keeping with our approach, we will not explain, again, the new BA process. However, the TE does offer some insight into how BA proceedings are expected to take place, and in that connection how Canada and the U.S. expect to prepare for them.

In recognition of the significant volume of cases in the pipeline, and to avoid a large number of cases becoming subject to arbitration immediately upon the expiration of two years from the entry into force of the provision, the TE provides that:

> "the competent authorities are encouraged to develop and implement procedures for arbitration by January 1, 2009 and begin scheduling arbitration of otherwise irresolvable MAP cases in inventory (and meeting the agreed criteria) prior to two years from entry into force."

Presumably, there will be a number of issues to resolve with the BA process, as they are encountered. One area where some have thought there to be uncertainty concerns whether BA can be used to resolve a dispute over an APA. The U.S. has recently made a favourable public statement concerning the BA provision of the U.S.-German treaty but there is no similar observation in the Canadian context. The only reference to an APA is in the context of the information necessary for the U.S. competent authority to begin the process (see para 16 of the Diplomatic Notes annexed to the 5th Protocol). One way of perceiving this reference is that it simply establishes, sensitive to U.S. procedure governing competent authority proceedings, when the U.S. competent authority will be considered to have had in its possession all information necessary to allow the BA proceeding to take place. If this is correct, then BA would not, *per se*, apply to a "failed APA". Rather, recognizing that an APA is simply a particular aspect of a MAP proceeding, an unresolved double tax controversy that had been the subject of an APA

would revert to the normal MAP and then, in that context, the new BA environment. Given that BA is to result in a specific financial outcome and not the determination of a methodology of other analysis, this seems more plausible than to assume that an APA, as such, would be the subject of a BA. However, unlike an APA, a MAP proceeding may be subject to limitations regarding prospective taxation years which "advance competent authority proceeding" practices such as Canada's "ACAP" program will have to address. This conceivably would limit the utility of BA to resolve continuing tax controversies for future, or even unaudited, taxation years.

It also appears that a BA decision could override a judicial determination on the issue in question (see Art XXVI(7)(e) as amended by the Protocol). This of course, presumes that the competent authorities would entertain a competent authority submission following such a judicial determination. Under Canadian procedures Canadian competent authority will only accept such a referral for the purpose of attempting to obtain relief from the other relevant jurisdiction. It is not clear that a competent authority could now refuse to consider such cases more fully and indeed to refer them to BA – having initially accepted them.

4. Guarantee Fees

Guarantee fees (in respect of indebtedness) are now dealt with in Article XXII – the Other Income Article. For Canada, this represents an agreement to treat such fees differently than its domestic law provides (i.e. deemed interest expense). As a result, there remains some confusion whether fees arising before the effective date of the Article XXII amendment will continue to be treated as interest and therefore be subject to withholding and the related party phase-in rule. A Department of Finance official has however indicated that the "Other Income" article should apply to exempt guarantee fees from Canadian withholding tax without regard to the interest exemption phase-in. But, the TE is silent in this respect.

There is an interesting comment in the TE to the effect that the clause of the Protocol in XXII (4) (to the effect that guarantee fees attributable to a PE would be governed by Article VII and not Article XXII) was added at the request of the U.S. The addition of such a rule would not be unexpected and is in fact the norm for interest dividends and royalties. However, the following comment is of note:

> ".. Compensation paid to a financial services entity to provide a guarantee in the ordinary course of its business of providing such guarantees to customers constitutes business profits dealt with under the provisions of Article VII. <u>However, provision of guarantees with respect to debt of related parties is ordinarily not an independent economic undertaking that would generate business profits</u>, and thus compensation in respect of such related – party guarantees is, in most cases, covered by Article XXII."

This suggests a threshold to the application of Article VII that would not previously have been surmised. In particular, we wonder whether a similar comment might not be made in respect of management fees.

5. <u>**Treaty Abuse - General**</u>

The bilateral application of the new "Limitation on Benefits" ("LOB") provision, about which we say more later, has attracted most of the attention directed to the Treaty's response to tax avoidance. However, paragraph 7 of Article XXIX A restates a previous general anti-abuse provision which applies in addition to, and is not supplanted by, the LOB provision. Formerly, though it was not so restricted, this provision was commonly thought to be Canada's anti-abuse rule for the Convention, as it had not acceded in the last protocol to adopt the existing LOB provision. In part, at least, this is understood to have been because Canada does believe, in this and its other treaties, that there is an implicit limitation against using a treaty for tax avoidance

purposes and that a specific LOB was unnecessary and perhaps would imply negatively a lack of confidence in or correctness of its position. It should be noted that the general anti-abuse rule in the existing Convention was not confined in its application to Canadian tax and despite the U.S. particularity of the present "one way" LOB provision in the existing Convention also applied for purposes of U.S. taxation.

The restated Article XXIX A(7) is, specifically, a general anti-treaty abuse provision that is articulated without reference to any particular standard found in each Treaty partner's anti-abuse law, although the TE at least allows for the application of the relevant domestic law – in Canada's case the GAAR ("general anti-avoidance rule"). The TE has the effect of entrenching this general anti-abuse provision more clearly and possibly amplifying its scope, force and intended effect.

There is a question, however, whether Article XXIX A (7) invokes a stand alone treaty standard of abuse – an international revenue or treaty law practice or convention, or whether it is merely the portal for the application of relevant domestic law of the treaty partners (if this is even a distinction, in the circumstances). The provision, itself, is simply a reservation of blanket authority to deny treaty benefits where "…to do otherwise would result in an abuse of the provisions of this Convention." This is not, in the main, language of art in the anti-tax avoidance law of either treaty partner though Canada's GAAR does incorporate the notion of the abuse of the Canadian *Income Tax Act* and Canadian treaties.

The TE seems to shed some light on this in a fashion that will not be intuitive to and may be resisted by many. Doubters in the Canadian context, in particular, may refer to the common, but possibly debatable, significance attached to Canadian Court decision in the *MIL Investments S.A.*

case.[15] Many believe that case to stand for the positive assertion, almost as a principle, that there is no implicit anti-abuse notion in treaties. In the circumstances of that case, the Courts chose not to, or possibly by force of circumstance did not have the basis to, find treaty abuse on any score, but reasonable observers could disagree on whether the circumstances of that case were determinative (and limiting) in that case and its significance therefore should be understood less enthusiastically. The TE refers to the independent status of paragraph 7 as a reflection of "…the right of a Contracting State to deny benefits under the Convention where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Convention.

The TE says that paragraph 7 "…allows a Contracting State to rely on general anti-avoidance rules to counter arrangements involving treaty shopping through the other Contracting State," and that each State can apply its domestic anti-avoidance rules and doctrine to deny treaty benefits. But this seems to be an inclusive, and not an exclusive, connotation of the provision. Indeed, the TE seems to do much more than simply imply or infer that a general anti-abuse notion inheres in tax treaties generally. In fact it states this and reflects this understanding in light of OECD's Commentaries to its Model Tax Convention. Given the considerable attention that the *MIL Investments* case has attracted, paragraph 7 and the accompanying comments in the TE deserve at least as much attention as the more formulaic LOB aspect of the LOB provision in the Protocol. This particular discussion in the TE has significance beyond the Convention: "The statement of this *principle* explicitly in the Protocol is not intended to suggest that the *principle* is not also *inherent* in other tax conventions concluded by the United States or Canada." (Emphasis added) The principle, in the context of the explicit Protocol language speaking of treaty abuse, is the permissive application of each State's anti-abuse law to counter treaty abuse, but this is only permissive, not exclusive, and its overarching context is the OECD

[15] MIL Investments S.A. v. R., 2007 DTC 5437 (FCA); 2006 DTC 3307 (TCC).

Commentaries which through attentive to domestic anti-abuse law as an avenue to counter treaty abuse are not so limited expressly or contextually.

6. **Limitation on Benefits**

The Convention has, since the last Protocol (the Fourth) contained a prescriptive anti-avoidance limitation, until the Fifth Protocol, confined to limiting access to relief from U.S. tax. As we note this was not the only anti-avoidance provision in the Convention applicable to U.S. tax but, consistent with U.S. treaty policy then prevailing and now much more fully developed, the LOB was seen as the principal device to confine U.S. tax benefit in the Convention to those for whom it was intended. The new LOB is fully bilateral. It incorporates terms and characteristics that touch on and may be terms of art in U.S. and Canadian domestic tax law. Certain terms and more generally the reach of the provision were not entirely clear in the Protocol itself. The TE is revealing in various respects.

(a) "Active Business" - Breadth

Paragraph 1 of Article XXIX A of the Treaty states that only a "qualifying person," as defined in paragraph 2 of Article XXIX A, is entitled to benefits under the Treaty, except as provided in paragraphs 3 (the "Active Trade or Business Test"), 4 (a derivative benefits test) and 6 (competent authority relief). The Active Trade or Business Test in paragraph 3 of Article XXIX A provides that a resident of a contracting State that is not a qualifying person may nevertheless qualify for Treaty benefits with respect to an item of income derived from the other State if the income is connected or incidental to a trade or business carried on in the first State, but only if that trade or business is substantial in relation to the activity carried on in the other State. In full, paragraph 3 of Article XXIX A, with the changes introduced by the Fifth Protocol, reads as follows:

> Where a person is a resident of a Contracting State and is not a qualifying person, and that person, or a person related thereto, is engaged in the active conduct of a trade or business in that State (other than the business of making or managing investments, unless those activities are carried on with customers in the ordinary course of business by a bank, an insurance company, a registered securities dealer or a deposit-taking financial institution), the benefits of this Convention shall apply to that resident person with respect to income derived from the other Contracting State <u>in connection with or incidental to that trade or business (including any such income derived directly or indirectly by that resident person through one or more other persons that are residents of that other State)</u>, but only if that trade or business is <u>substantial</u> in relation to the activity carried on in that other State giving rise to the income in respect of which benefits provided under this Convention by that other State are claimed.

Prior to the introduction of the Fifth Protocol, paragraph 3 of Article XXIX A applied only with respect to income derived by a resident of Canada from the United States.[16] However, apart from this difference, the Active Trade or Business Test following the Fifth Protocol is substantially the same as the test prior to the Fifth Protocol.

There are numerous conceivable examples to highlight the differences between the U.S. and Canadian interpretations of the meaning of "in connection with or incidental to the trade or

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[16] Paragraph 3 of Article XXIX A read as follows immediately prior to the changes made by the Fifth Protocol:

> Where a person that is a resident of Canada and is not a qualifying person of Canada, or a person related thereto, is engaged in the active conduct of a trade or business in Canada (other than the business of making or managing investments, unless those activities are carried on with customers in the ordinary course of business by a bank, an insurance company, a registered securities dealer or a deposit-taking financial institution), the benefits of the Convention shall apply to that resident person with respect to income derived from the United States in connection with or incidental to that trade or business, including any such income derived directly or indirectly by that resident person through one or more other persons that are residents of the United States. Income shall be deemed to be derived from the United States in connection with the active conduct of a trade or business in Canada only if that trade or business is substantial in relation to the activity carried on in the United States giving rise to the income in respect of which benefits provided under the Convention by the United States are claimed.

business". But we will merely observe that the Canadian domestic meaning of that expression is much narrower than the U.S. meaning according to the U.S. model convention or the TE. The Canadian Revenue Authority ("CRA") indicated at the Canadian IFA branch meeting on May 12, 2008 that it would apply Canadian jurisprudence in interpreting this provision. If that approach were in fact adopted, a U.S. subsidiary of a foreign parent (e.g. UK) would in most cases fail to qualify for dividend withholding tax relief in respect of dividends received from a Canadian subsidiary of the U.S. company. However, the TE deals with this issue by importing the U.S. interpretation.

> Income is considered derived "in connection" with an active trade or business if, for example, the income-generating activity in the State is "upstream," "downstream," or parallel to that conducted in the other Contracting State. Thus, for example, if the U.S. activity of a Canadian resident company consisted of selling the output of a Canadian manufacturer or providing inputs to the manufacturing process, or of manufacturing or selling in the United States the same sorts of products that were being sold by the Canadian trade or business in Canada, the income generated by that activity would be treated as earned in connection with the Canadian trade or business. Income is considered "incidental" to a trade or business if, for example, it arises from the short-term investment of working capital of the resident in securities issued by persons in the Sate of source.
>
> An item of income may be considered to be earned in connection with or to be incidental to an active trade or business in the United States or Canada even though the resident claiming the benefits derives the income directly or indirectly through one or more other persons that are residents of the other Contracting State. Thus, for example, a Canadian resident could claim benefits with respect to an item of income earned by a U.S. operating subsidiary but

> derived by the Canadian resident indirectly through a wholly-owned U.S. holding company interposed between it an the operating subsidiary. This language would also permit a resident to derive income from the other Contracting State through one or more residents of that other State that it does not wholly own. For example, a Canadian partnership in which three unrelated Canadian companies each hold a one-third interest could form a wholly-owned U.S. holding company with a U.S. operating subsidiary. The “directly or indirectly” language would allow otherwise unavailable treaty benefits to be claimed with respect to income derived by the three Canadian partners through the U.S. holding company, even if the partners were not considered to be related to the U.S. holding company under the principles of Code section 482.

As a result, it seems more clear (since Canada has expressly approved the TE) that the more expansive U.S. view of the meaning of the expression may prevail despite the CRA comment at the IFA meeting.

The TE comment concerning the “substantial” requirement is also helpful. Unlike other U.S. treaties which contain precise formulative tests, the TE described the requirement in more general terms and indicates that avoidance of treaty shopping is the target.

(b) Tiers of Entities - XXIX A(2)(d), (e), 3, 4

One issue that had been addressed favourably by the CRA is the application of the paragraphs noted above of the LOB provision. These provisions appear to preclude treaty entitlement whenever a non-qualified resident entity (such as an LLC) is in the chain of ownership between a qualified treaty resident and the Canadian payer of the income in question (for e.g. if a U.S. public company USCO indirectly holds its Canadian subsidiary shares by means of an intermediate U.S. LLC which holds a U.S. Corp (USCO2) which holds all the shares of Canco.

Dividends paid by Canco to USCO2 do not appear to be eligible for withholding tax relief. The CRA however indicated at the May 2008 Canadian IFA meeting that it would interpret these provisions by looking through or ignoring transparent entities (the LLC). In that case, USCO2 would qualify for relief since USCO1 is a U.S. public company. The TE follows through with this approach in a comprehensive fashion. It provides in respect of 2(a):

> By applying the principles introduced by the Protocol (e.g. paragraph 6 of Article IV) in the context of this rule, one "looks through" entities in the chain of ownership that are viewed as fiscally transparent under the domestic laws of the State of residence (other than entities that are resident in the State of source).

(c) "NAFTA Clause"

The U.S. has issued interesting technical interpretations that provide for relief under clauses similar to XXIX A(4) (e.g. Dutch NAFTA clause) for Article X, XI and XII purposes (dividends, interest and royalties) where the non resident entity's shareholder (e.g. Canadian parent owns greater than 90% of votes and value of DutchCo) is a "qualified resident" of a NAFTA country and the intermediate recipient would be entitled to a rate of tax "at least as low as" that exigible under the particular (e.g. Dutch-US) treaty if the intermediary were resident and carried on business in that country (e.g. Canada). The IRS has taken the view that the Canadian-US treaty (in our context) need not provide a rate as low as that available under the Dutch treaty. It can in some cases be granted less than most favourable rate treatment e.g. treated as entitled to a withholding rate under the Dutch-U.S. treaty that matches the rate that the Canadian treaty provides.[17]

[17] See M. Miller, When Derivative Benefits and Zero Withholding on Dividends Collide, Are Any Treaty Benefits Available, International Tax Journal, Sep-Oct, 2007.

Canadians who are planning to establish offshore Fincos in response to the new opportunities afforded by the Canadian nil withholding on U.S. related party interest (in conjunction with NAFTA clauses) should of course consider the following:

- ***"NAFTA Clause" and Base Erosion***. Most U.S. derivative benefit clauses impose a base erosion limitation on the applicability of the NAFTA clause (e.g. maximum 50% reduction of the amount of taxable income that an offshore Finco can effect without losing the benefit of the clause). It is therefore very important that this ratio be carefully monitored if the relevant local tax reduction mechanism involves a loan from another jurisdiction. The anti-conduit rule discussion below also bears on this point. Some jurisdictions grant relief in respect of imputed interest on non-interest bearing ("NIB") loans. These regimes may also be within the ambit of the base erosion limitation. In this context, "expenses" could include deemed expenses; the U.S. could recharacterize such an NIB loan as bearing interest. However, regimes under which a deduction is granted in respect of equity funding (e.g. Switzerland) would seem to escape the application of the rule.

- ***Interest Deductibility***. Canada has enacted section 18.2 of the Canadian *Income Tax Act*. The tax policy reasons why expenses incurred to earn foreign exempt income might be limited are not difficult to imagine or understand. Indeed this seems to be a subject of current tax policy discussion in various countries. On the other hand it could reasonably be debated whether the approach adopted in section 18.2, presented as it was as an anti-tax haven measure, has the most appropriate focus or adopts the most workable technique consistent as well with tax policy underlying the earnings of exempt foreign income. Be that as it may, if this provision does in fact become effective and withstands the current

inquiry into Canada's international tax rules (which is not, specifically in any event, meant to review interest deductibility), it will make the traditional double dip (that relies on 95(2) of the Canadian *Income Tax Act*) ineffective. It would be advisable to take steps as soon as possible to implement cash management strategies consistent with the CRA's practices to permit the accumulation of a sufficient amount of unborrowed funds (properly segregated) in time to fund an offshore finance company.

- ***US Debt/Equity Rules***. Those with Hungarian, Icelandic or other similar group structures for investment into the United States take care to avoid the results obtained in the *Laidlaw* case. From a Canadian perspective, and we would say also in U.S. tax terms, that case concerned a structure, like many if not most, in which diligent and continuous observance of corporate and organizational form and the terms of instruments was critical to ensuring the desired tax effect. That concern will continue to pervade corporate planning. If anything the Protocol and the TE reflect some antipathy to highly structured corporate planning, using hybrid entities at least. Accordingly, the *Laidlaw* case and this sense of the Protocol may be a cautionary tale that endures even after the Protocol is in force.

- ***US Anti-Conduit Rules (1.881-3)***. It is critical that there not be two "financing transactions" as part of the double-dip arrangement. Canadian parents should pay close attention to how they source the funds provided to an offshore Finco.

- ***Earnings stripping IRC 163(j)***. Much has been written about this U.S. rule limiting interest deductibility. It is of course important that the formula incorporated in this rule be monitored applying all the relevant information, and that parent guarantees of a U.S. subsidiary's third party debt be avoided. But also, attention should also be directed to

U.S. legislative developments. There have been several proposals made to reduce the percentage limit from its current 50% rate and to eliminate the ability to carry forward disallowed interest expenses.

- ***Beneficial Ownership***. In a number of places, the TE consistently reflects an expectation that "beneficial ownership" takes its meaning from the law of State seeking to impose tax. This significance of this term is as much a property law matter as possibly, a tax avoidance limitation in tax treaties. Judicial and administrative determinations in various countries have raised questions about whether there are at least three possible meanings: a source, or taxing, State meaning; a residence State meaning; and an "international fiscal meaning" epitomized by the United Kingdom Courts' decisions in the *Indofood* case,[18] one among several cases and rulings of various countries contending with this notion. Among other things it is not clear that the "international meaning", if there be one, necessarily is different than either of the other possibilities particularly under Canadian law. This is a factor that should affect how the TE's comments are approached. In the U.S., the immediate significance of this issue is identified with the *Aiken Industries*[19] case. In Canada, interest in "beneficial ownership" in a treaty context is much more current. The *Prévost Car*[20] case, won by the taxpayer at first instance in the Tax Court of Canada, faces an appeal to the Federal Court of Appeal. At issue in that case was whether a holding company structure should be respected so as to result in dividends ostensibly received by the holding company benefiting from the reduced rate of withholding tax between Canada and the holding company's residence State,

[18] Indofood International Finance Ltd. v. JP Morgan, Chase Bank N.A. London Branch, [2006] EWCA Civ. 158.

[19] Aiken Industries v. Commissioner of Internal Revenue, 56 TC 925 (1971).

[20] Prévost Car Inc. v. The Queen, 2008 TCC 231.

The Netherlands. Evidence as to influence exercised in various ways by the holding company's shareholders, notably with respect to dividend payments by *Prévost Car*, the Canadian company, underlie arguments concerning "beneficial ownership" presented in this case. The Tax Court also took into account evidence pertaining to the OECD's intended meaning of "beneficial ownership" when introduced in its Model Tax Convention and as used in its conduit report in the mid-1980's, Canadian domestic law as to notions of common and civil law ownership, relevant foreign law of the recipient of dividend payments and other legal considerations including the possibility of an "international fiscal meaning".

In this context, two among possibly several considerations are notable. First, the TE does seem to reflect a bias in favour of a source State meaning of "beneficially owned", although as we note whether this is different than an "international meaning" is not clear or resolved by the TE. Second, this decision of the Tax Court in the *Prévost Car* case was influenced by its facts in relation to the party that should have been considered to "earn" a dividend. Accordingly its significance, broadly or as a statement of principle, may be limited.

Canadian taxpayers should not assume that a U.S. court would adopt the decision of the Tax Court of Canada in *Prévost Car*, or for that matter that the taxpayer's success at the Tax Court of Canada stage will survive scrutiny by the Federal Court of Appeal. To the last point, then, care must be taken to ensure that foreign companies, particularly holding or financing affiliates whose functions may by force of circumstance be quite limited, have the requisite "dominion and control" over their income earned and any financial accommodations or furnishing of property to a U.S. entity. The declaration of dividends

should not be automatic and it would be prudent if not indeed necessary for the board of directors to consider, and to be seen to consider, financial results and other relevant factors before dividends are declared, and otherwise to conduct itself in a fashion consistent with its legal responsibility to exercise real control and direction.

- ***Corporate Residence***. It is important for Canadian purposes to ensure that a financing or holding company is resident in the relevant treaty country for purposes of the relevant double tax treaty *and* generally at common law. The United Kingdom Holden vs. Wood[21] case is very helpful in this regard. It takes a fairly modernistic view of the residence rule, and recognized that limited purpose companies in a corporate group are no less resident where they purport to be resident simply because supervisory corporate group policies and indeed the group parent influences its conduct as long as the powers of its board of directors are not usurped. However, the more recent *Smallwood Estate*[22] case in the United Kingdom and the reduction in the emphasis on the place where directors meet in determining the "place of effective management" under 2008 changes to the OECD Model Tax Convention Commentary suggest that taxpayers should use a degree of caution in establishing the groundwork for a residence determination. These arrangements, and the relevant law in general, enshrine the "fiction" of corporate personality. At the very least taxpayers and their advisors should conduct themselves fully in accordance with the expectations of the legal fiction, formalistic though they may be.

[21] Wood v. Holden, [2006] STC 443 (CA); [2005] STC 879 (HC); R. v. Holden, [2004] STC (SCD) 416.

[22] Trevor Smallwood Trust v. Revenue & Customs, [2008] UKSPC SPC 00669; SPC 00669.

7. Hybrid Entities Article IV(6) – "Looking Through"

(a) "Beneficial Owner", "Derived By".

The TE introduces a new regime to deal with the granting of treaty benefits to owners of interests in hybrid entities such as U.S. LLCs pursuant to Article IV(6)

The residence State principles determine who "derives" income, profits or gains. But source country principles of beneficial ownership apply to determine whether the person who derives the income, profit or gains, is also the beneficial owner. We spoke about "beneficial ownership" earlier.

The TE provides though that the tested party (for beneficial ownership purposes) in the case of Canadian source income paid to a U.S. LLC ("limited liability company") would be the LLC (not the members of the LLC). To the extent the LLC is considered the beneficial owner of the income under Canadian principles, U.S. residents who are viewed as deriving income therefrom per Article IV(6) could be eligible for treaty benefits. It is not entirely clear how these principles apply in the LOB provision, however.

(b) Filing Requirements, PE

The TE discusses filing requirements and permanent establishment determinations in respect of such hybrid situations. The TE should be very carefully considered in this respect. For example, when a U.S. LLC is earning income from Canada, only the presence and activities of the LLC are considered in determining if there is a PE. In the converse situation, the U.S. looks at the activities of a person who is considered to derive income through an entity as well as the presence and activities of the entity.

(c) Proportional Ownership Article X(2)(a)

The eligibility for 5% withholding tax on dividends in Article X depends on ownership of at least 10% of the voting stock of the payer company. The Protocol applies a look through rule where a resident of one country owns stock of another through a fiscally transparent entity. The attribution is to be "in proportion to the company's ownership interest in that entity". Although "fiscal transparency" has been clarified in the TE (as mentioned below), this rule has not and in particular fails to deal with situations where there are multiple classes of interest held. The example provided does not provide any indication as to the result where the interest held in the entity is, for example, non-voting.

(d) "Fiscal Transparency"/"Same Treatment"/"S Corps"

As expected, the TE adopts the U.S. notion of fiscal transparency. These are entities the income of which is taxed at the beneficiary, member or participant level. Entities that are subject to tax, but with respect to which tax may be relieved under an integrated system, are not fiscally transparent.

The requirement of "same treatment" is to be determined under the principles of U.S. Code section 894 and the related regulations. The relevant paragraph of the TE provides as follows:

> Under both paragraph 6 and paragraph 7, it is relevant whether the treatment of an amount of income, profit or gain derived by a person through an entity under the tax law of the residence State is "the same as its treatment would be if that amount had been derived directly." For purposes of paragraphs 6 and 7, whether the treatment of an amount derived by a person through an entity under the tax law of the residence State is the same as its treatment would be if that amount had been derived directly by that person <u>shall be determined in</u>

> accordance with the principles set forth in Code section 894 and the regulations under that section concerning whether an entity will be treated as fiscally transparent with respect to an item of income received by the entity. Treas. Reg. section 1.894-1(d)(3)(iii) provides that an entity will be fiscally transparent under the laws of an interest holder's jurisdiction with respect to an item of income to the extent that the laws of that jurisdiction require the interest holder resident in that jurisdiction to separately take into account on a current basis the interest holder's respective share of the item of income paid to the entity, whether or not distributed to the interest holder, and the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity. Although Canada does not have analogous provisions in its domestic law, it is anticipated that principles comparable to those described above will apply.

Although the U.S. rules would treat an S Corp as a fiscally transparent entity (and the U.S. will so treat it), Canada will continue to grant treaty benefits to an S Corp.

8. Hybrid Entities IV(7) Denial of Benefits

Despite the concerns expressed by practitioners, business people and the U.S. Joint Committee, no modifications in the apparent impact of IV(7)(b) are offered in the TE, although further discussions on this issue between the treaty partners appear likely. U.S. owners of Canadian ULCs will be denied treaty benefits with respect to ownership and income derived from such entities – even in respect of non-deductible dividend distributions.

Although Article IV(7)(a) is similar in effect to U.S. Code section 894(c) and related regulations, it is much broader in scope. It applies to business profits as well as passive income. The TE indicates that for the purpose of the Convention by the U.S., the treatment of affected payments under Code section 894(c) and the regulations thereunder would not be relevant.

This provision may also preclude a Canadian corporation from obtaining branch tax rate relief in the U.S. where it carries on activities there using a disregarded LLC (since the LLC is disregarded for U.S. purposes but not for Canadian tax purpose).

All In All . . .

The TE provides some very helpful insight into the significance of various aspects of the Protocol, although a number of potentially problematic aspects are not addressed. It is almost axiomatic, in the contemporary tax world, that any tax provision will raise questions about its meaning and scope. Inevitably as the manner in which international business is conducted makes it more difficult to clearly and confidently align elements of that business with particular countries to the exclusion of others, all faced with applying international tax rules confront difficult and sometimes lonely judgments. This is only compounded in a treaty context. Because of a treaty's intrinsically contractual nature, a less legalistic and possibly semantic interpretative approach is favoured. As well there is the undeniable difficulty in meshing the application of two entirely separate tax systems to avoid gratuitous taxation by either, where each can assert a legitimate tax claim in the first instance and the relevant circumstances may well not have been in the obvious contemplation of the treaty.