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CANADIAN UNLIMITED LIABILITY COMPANIES (ULCs) – IMMINENT PROBLEMS POSSIBLE SOLUTIONS AND NEW CRA INSIGHTSBY MATTHEW PETERS, CHRISTOPHER J. STEEVES, ZAHRA NURMOHAMED¹

A popular hybrid entity for U.S. residents seeking to invest in Canada has been the unlimited liability company ("ULC"). The corporate law of certain Canadian provinces (*i.e.* Nova Scotia, Alberta and British Columbia) allows for the incorporation of ULCs, which have proliferated over the years largely because of the fact that they qualify for "check-the-box" treatment under the Treasury Regulations to the U.S. *Internal Revenue Code*. This treatment generally permits U.S. resident investors to access a combination of Canadian and U.S. tax benefits that are otherwise unavailable in respect of Canadian investments made through other corporate entities.

A Treaty Problem Is Quickly Approaching

The Fifth Protocol (the "Protocol") to the *Canadian-United States Income Tax Convention* (the "Treaty") should cause every U.S. business to re-evaluate, before the end of 2009, the continuing tax efficiency of their Canadian ULCs. As of January 1, 2010, the Protocol will eliminate all Treaty benefits in respect of amounts derived by a U.S. resident through a ULC that has elected under the "check-the-box" rules to be treated as fiscally transparent for U.S. tax purposes. In many instances, this will result in a significant increase in the Canadian tax cost of maintaining ULC structures, including an increase in the following withholding taxes:

- from 5% to 25% on dividends from a ULC to a U.S. corporate shareholder owning at least 10% of the voting stock of the ULC;
- from 15% to 25% on all other dividends from a ULC;

¹ The discussion provides a high-level overview of certain issues and is not intended to be construed as legal advice.

- from 0% to 25% on interest paid by the ULC to a related U.S. person;² and
- from 0% (or 10% in some cases) to 25% on royalties.

Other Canadian Tax Problems Are Already Here

Recent amendments to the Regulations under the *Income Tax Act* (Canada) (the "Act") may also increase the overall Canadian tax liability of certain ULCs (in particular, Nova Scotia ULCs) that are primarily used as passive investment holding companies. These amendments, which will deem certain ULCs to have a permanent establishment in a province in certain circumstances, could significantly increase the ULC's Canadian tax liability.

Additional U.S. Tax Issues On The Horizon

The tax-effectiveness of ULC structures will require further consideration in light of recent proposals to reform the domestic U.S. "check-the-box" regime. The scope of these proposals and the likelihood that they will be enacted are presently unclear. However, this is another issue that U.S. residents will need to closely monitor in the coming months when assessing the tax efficiency of ULCs in Canada.

How Real Are The Problems?

Since the changes to the Regulations to the Act are already in force, U.S. businesses should consider how these changes might affect their existing ULC structures.

Recently, the Canada Revenue Agency ("CRA") has made public statements that may assist U.S. businesses with ULC structures in some situations.

As indicated above, the proposed U.S. domestic changes to the "check-the-box" rules are uncertain, and

² Generally, the withholding tax rate on interest paid by a Canadian resident to a related U.S. resident in the 2009 calendar year is 4%, but will be eliminated in respect of interest paid in the 2010 calendar year.

their progress through the legislative channels must be closely monitored.

There Are Solutions

There are many potential solutions to the problems created by the changes to the Regulations and the Treaty. Every U.S. investor will have its own unique circumstances to consider and its own tax strategies that will dictate the manner in which it approaches these issues. With careful planning, the tax efficiency of existing cross-border structures can be managed, and in some cases, preserved. With respect to the domestic tax changes, consideration should be made to converting the ULC to a generic Canadian corporation and then migrating to a lower tax province such as Alberta to minimize potential Canadian tax exposure.

There are some possible alternatives to mitigate the potential loss of Treaty benefits. For example:

- It may be possible for U.S. residents to reorganize the shareholdings of the ULC (*i.e.* by interposing a fiscally-transparent foreign holding company between the U.S. resident and the ULC);
- Instead of paying dividends, it may be possible to structure the payment as a return of capital for Canadian tax purposes;
- It may be desirable for the ULC to elect to be treated as a corporation for U.S. tax purposes, as opposed to a fiscally-transparent entity;
- The ULC may be liquidated or gradually wound-up and its business activities could be carried on through a branch for Canadian tax purposes;
- Royalty and non-arm's length interest payments from the ULC could be restructured; or
- All retained earnings of the ULC could be paid out prior to the effective date of the proposals, benefiting from the current reduced withholding tax rates.

These are but a few of the potential "fixes" that U.S. businesses and their tax advisors may pursue, each of which comes with its own distinct array of Canadian and U.S. tax consequences that must be considered prior to implementation and in conjunction with any changes to the U.S. "check-the-box" rules.

Additionally, on November 24, 2009, the CRA made a few important announcements at the Annual Conference of the Canadian Tax Foundation in Toronto. These announcements included new guidance regarding acceptable alternatives for avoiding higher rates of Canadian withholding tax that would otherwise be imposed on certain payments made by ULCs after December 31, 2009.

First, the CRA has indicated that where a ULC increases its paid-up capital on its shares held by a U.S. Company so that a deemed dividend arises for Canadian tax purposes, provided that such transactions would be disregarded for U.S. purposes whether or not the ULC was fiscally transparent, the low Treaty rate would apply for Canadian tax purposes. The CRA indicated that the General Anti-Avoidance Rule ("GAAR") would not apply provided the U.S. Company used the ULC to "carry on an active branch operation in Canada". However, the CRA was silent on the application of the GAAR to a ULC that is used as a passive holding company.

Second, in light of the Federal Court of Appeal's decision in *Prévost Car*, the CRA stated that the reduced withholding rate will normally apply to dividends paid by the ULC to a Luxembourg intermediary ("Luxco") when the Luxco is interposed between the U.S. Company and ULC and the Luxco is the "beneficial owner" of the dividends. The CRA also indicated that the GAAR would not apply in these circumstances provided the U.S. Company used the ULC to "carry on an active branch operation in Canada".

Third, the CRA indicated that when the ULC owes interest to its U.S. parent company and the debt is restructured whereby it becomes payable to its U.S. grandparent company rather than the parent company, the reduced rates of withholding tax would apply (0% in 2010) in situations where the interest payments are treated the same in the hands of the grandparent company as it would in the hands of the parent company. Such payments will not be offensive to the Treaty so long as they do not involve "double dipping" in which case the GAAR may apply.

Next Steps

The best advice is to re-evaluate the tax-effectiveness of your current ULC structure, and consider all available options to mitigate the increased Canadian tax costs associated with the Treaty and domestic law changes.

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