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Breaking Developments in Tax Law | 07/14/09

Investing in Canada Through a U.S. Limited Liability Company: The Impact of New Paragraph 6 to Article IV of the Canada-U.S. Tax Treaty

Since January 1, 2009, new tax rules affecting fiscally transparent entities investing into Canada have been in place. These new rules emanate from changes to the United States – Canada Income Tax Convention (the "Treaty") as a result of the Fifth Protocol (the "Protocol") to the Treaty which was signed December 15, 2008.

In view of the changes to the Treaty, cross border structures used by U.S. and Canadian businesses and investors deserve to be reviewed and reassessed. In particular, U.S. residents should review whether their investments into Canada should be structured or restructured to benefit from the new tax advantages that arise when such investments are structured through a fiscally transparent entity, such as a U.S. limited liability company, which, prior to the Protocol, did not qualify for Treaty benefits.

Impact of Paragraph 6, Article IV of the Treaty on Fiscally Transparent Entities Like LLCs

New paragraph 6, Article IV of the Treaty affects the source country taxation of income, profit or gain derived through or paid to entities that are treated as fiscally transparent entities under the law of either Canada or the United States but that are treated as corporations in the other country. The benefit of this new paragraph is that dividends, interest and business profits earned in Canada or the United States by certain fiscally transparent entities in the other country may finally be entitled to reduced tax rates.

In general, a fiscally transparent entity means an entity that's income is taxed at the beneficiary, partner, member or participant level. Fiscally transparent entities for U.S. tax purposes include: partnerships, common investment trusts under Section 584, grantor trusts, business entities such as limited liability companies that are treated as a partnership or disregarded entity for U.S. tax purposes, and S corporations.[1] In Canada, fiscally transparent entities would include partnerships and "bare" trusts. Although not the only consequence of paragraph 6, Article IV, it is generally accepted that the main purpose of paragraph 6 is to allow U.S. investors to engage in business or otherwise invest in Canada through a fiscally transparent U.S. limited liability company ("LLC") and still be entitled to Treaty benefits.

Prior to enactment of the Protocol, Canadian source income received by a fiscally transparent U.S. LLC entirely owned by U.S. persons would not benefit from reduced Canadian withholding

[1] Despite the treatment of an S corporation as a fiscally transparent entity, S corporations are somewhat of a special case. Although under paragraph 6, where an S corporation is owned by U.S. residents, the U.S. residents will be considered for purposes of the Treaty as the person that derives the income, Canada accepts the S corporation as a resident in its own right and therefore allows it to benefit from the Treaty.

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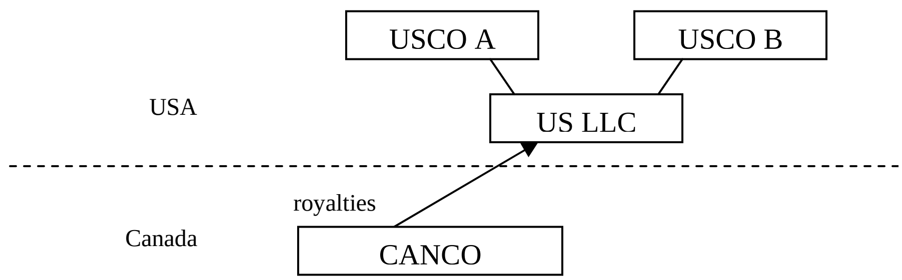
rates or the permanent establishment ("PE") requirements even though the U.S. owners of the LLC would have benefited from the reduced Treaty rates if those owners had made the investment into Canada directly. This seemingly unfair tax result occurred because Canada, under its tax rules, characterizes a U.S. LLC as a corporation and therefore a taxpayer in its own right. Since the U.S. LLC is a corporation under Canadian rules, but a disregarded or pass-through entity whose members (rather than the LLC itself) are subject to tax on the earnings of the LLC for U.S. tax purposes, Canada's position is that the U.S. LLC is not a resident for Treaty purposes and therefore not entitled to Treaty benefits.

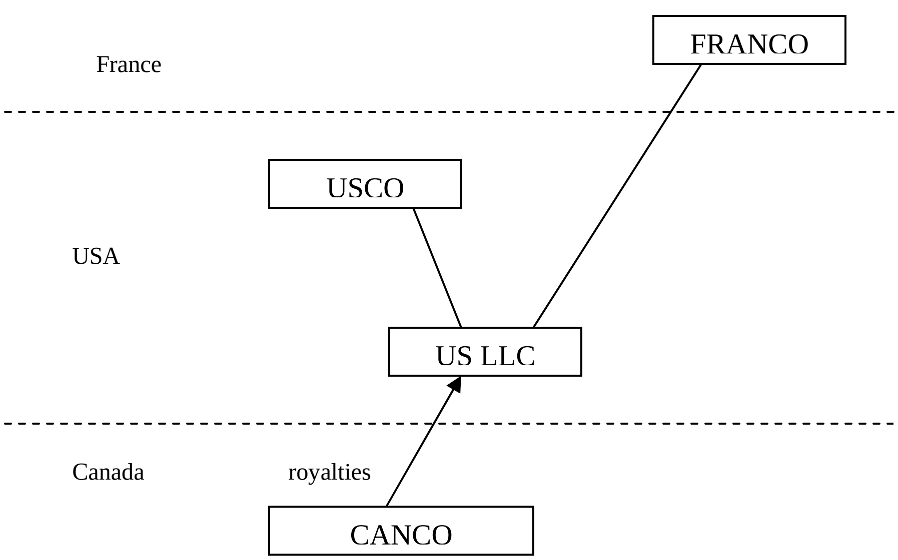
New paragraph 6, Article IV addresses this disparity in treatment by requiring that a fiscally transparent entity like an LLC be looked through and eligibility for Treaty benefits be determined at the beneficiary level. Thus, if the beneficiary is a U.S. resident, the Canadian income will be treated as earned by the U.S. resident and therefore eligible for Treaty benefits.

Below is an illustration of how paragraph 6, Article IV might impact a U.S. LLC receiving royalties from a Canadian corporation.



Paragraph 6 applies to enable USCO A and USCO B to claim reduced Canadian withholding tax on the royalty payments from CANCO to US LLC.

As Treaty benefits are determined at the member level (using an LLC as the example), where some owners of the U.S. LLC are not U.S. persons, Treaty benefits may be denied to that non-U.S. member's allocable share of Canadian source income earned by the LLC. Compare the example above to a situation where ownership of U.S. LLC is split between a U.S. resident and a non-U.S. resident:



Look at the beneficiaries to determine if the royalty payment will be subject to withholding in Canada and at what rate.

Portion of the royalty payment allocated to USCO will benefit from 10% or no withholding under the Treaty.

Portion of the royalty payment allocated to FRANCO will be subject to withholding at a rate of 25%; therefore, FRANCO would have had a better result if its portion of the royalty was paid directly to FRANCO and the U.S. – France Treaty rate of 0% or 5% for royalties applied.

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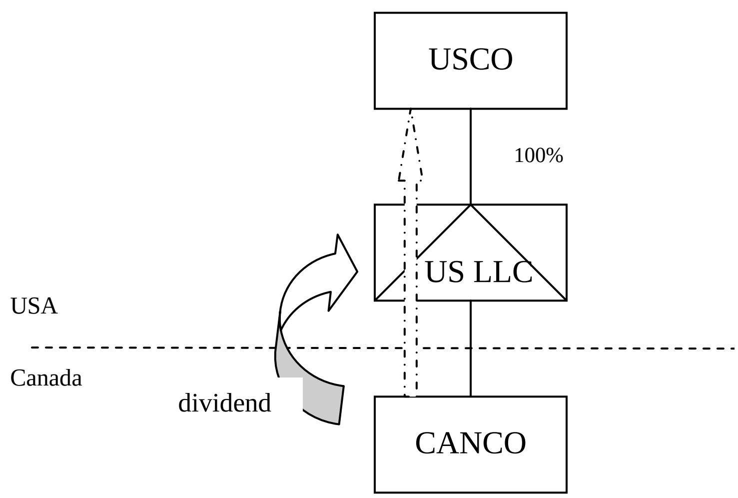
This disparate tax treatment between U.S. versus non-U.S. members of an LLC investing in Canada is sure to create additional complications to business planning, negotiations between the members and drafting of the LLC operating agreement.

Adding to the complications arising from this provision, at the time the Protocol was released, it was not clear whether each member of the U.S. LLC would be required to file Canadian tax returns, which would obviously create significant hardship where there were numerous investors in the LLC. The U.S. Treasury's Technical Explanation of the Protocol ("TE") resolved this confusion, however, explaining that despite "looking through" the U.S. LLC to determine if the income, profit or gain derived through or paid by a U.S. LLC should qualify for Treaty benefits, Canada will continue to treat the U.S. LLC as a taxpayer in its own right. As a result, the U.S. LLC (rather than each member) will be required to file any required Canadian income tax returns to claim the benefit of the Treaty.

The following examples further illustrate and explain new paragraph 6, Article IV:

U.S. company receiving dividends from a Canadian corporation through a wholly-owned U.S. LLC.

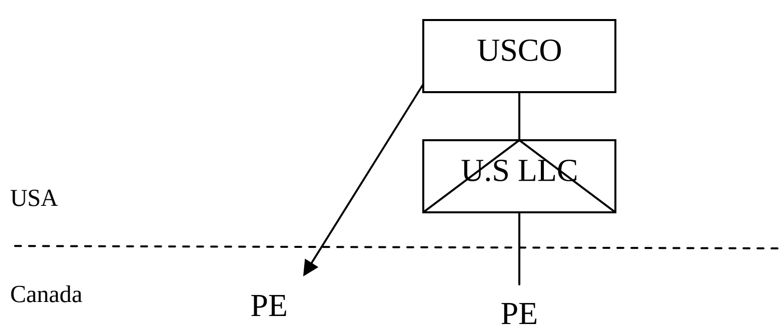


Paragraph 6 applies to enable USCO to claim reduced Canadian withholding tax.

US LLC is treated as fiscally transparent for U.S. purposes and the income is treated as if derived by USCO directly.

CANCO pays a dividend to US LLC.

If the Canadian income earned by the U.S. company is business profits under the Treaty, the determination of whether the income is subject to tax in Canada because it was attributable to PE will be based on the presence and activities in Canada of the U.S. LLC itself, not of the members acting in their own right.



U.S. LLC's profits are treated as derived by a U.S. person, because US LLC is fiscally transparent; however, US LLC is the Canadian taxpayer; therefore, the separate PE of USCO is ignored and only U.S. LLC's business activity is tested.

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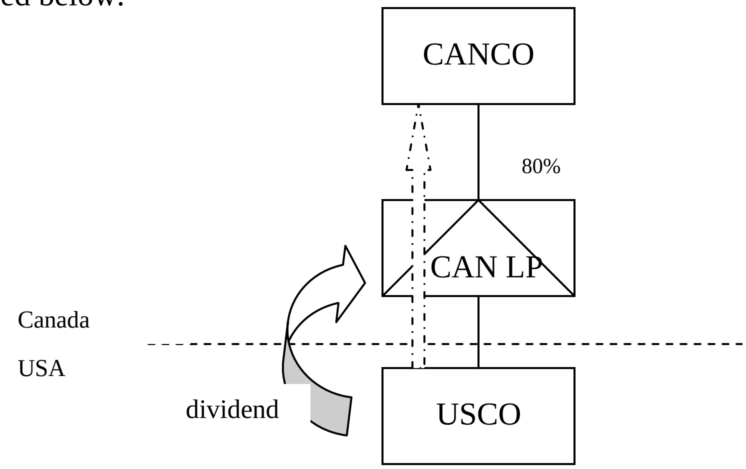
Paragraph 6, Article IV also applies to allow Treaty benefits for U.S. source income derived by a Canadian partnership that is treated as a corporation for U.S. tax purposes. This situation is illustrated below.

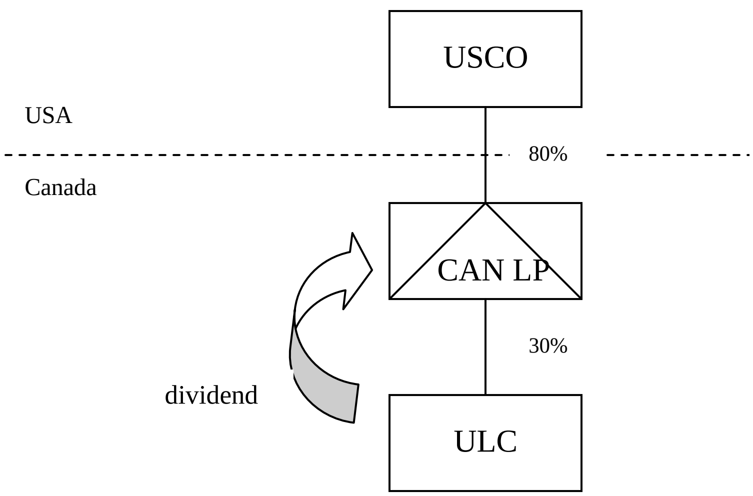


Paragraph 6 applies to enable CANCO to claim reduced U.S. withholding rate.

CAN LP is treated as fiscally transparent for Canadian tax purposes and as a corporation for U.S. tax purposes. The dividend is treated as if derived by CANCO directly.

USCO pays a dividend to CAN LP.

Paragraph 6, Article IV includes parenthetical language, the effect of which is to deny Treaty benefits to an amount of income that is derived through a fiscally transparent entity that is a resident of the source country. Although the TE does not provide any insight into this provision, commentators have posed that the purpose of the inclusion was to prevent amounts received from a Canadian unlimited liability company ("ULC") owned by a fiscally transparent entity from receiving Treaty benefits. The probable effect of the parenthetical is represented by the following:



Because the fiscally transparent entity is formed in the source state (Canada), Paragraph 6 *does not* apply to reduce the Canadian withholding rate.

CAN LP is treated as fiscally transparent for Canadian purposes and as a corporation for U.S. purposes.

ULC pays a dividend to CAN LP.

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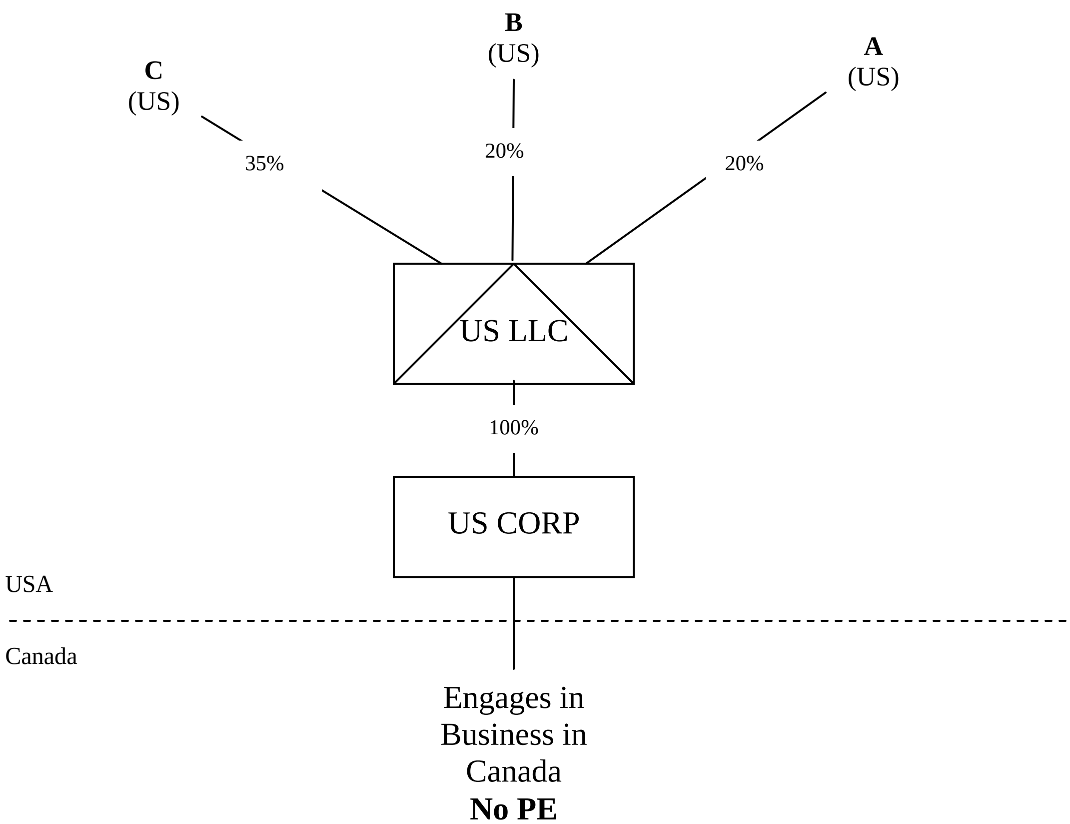
Paragraph 6 and Limitations of Benefits.

Prior to the Protocol, Article XXIX of the Treaty – Limitations of Benefits applied to the United States only. As a result of the Protocol, the Limitations of Benefits ("LOB") has been expanded to include Canada, and represents the first time Canada will be bound by a Limitations of Benefits Article. As a result, not only will the recipient of income be required to be a resident as defined in Article IV, but the recipient must also meet the LOB article.

Prior to the Protocol, in the example below, because U.S. LLC was not a "resident" for Treaty purposes, U.S. Corp would not be a qualifying person, as defined in Article XXIX. As a result, U.S. Corp's Canadian source business profits would be subject to Canadian tax. According to the TE, after the effective date of the Protocol, however, the look-through rules of paragraph 6, Article IV will apply to determine if U.S. Corp is a qualifying person. As all of the owners of U.S. LLC are U.S. persons, U.S. Corp is a qualifying person and its Canadian source business profits will not be subject to tax in Canada because of the absence of a permanent establishment.

Ex. 1



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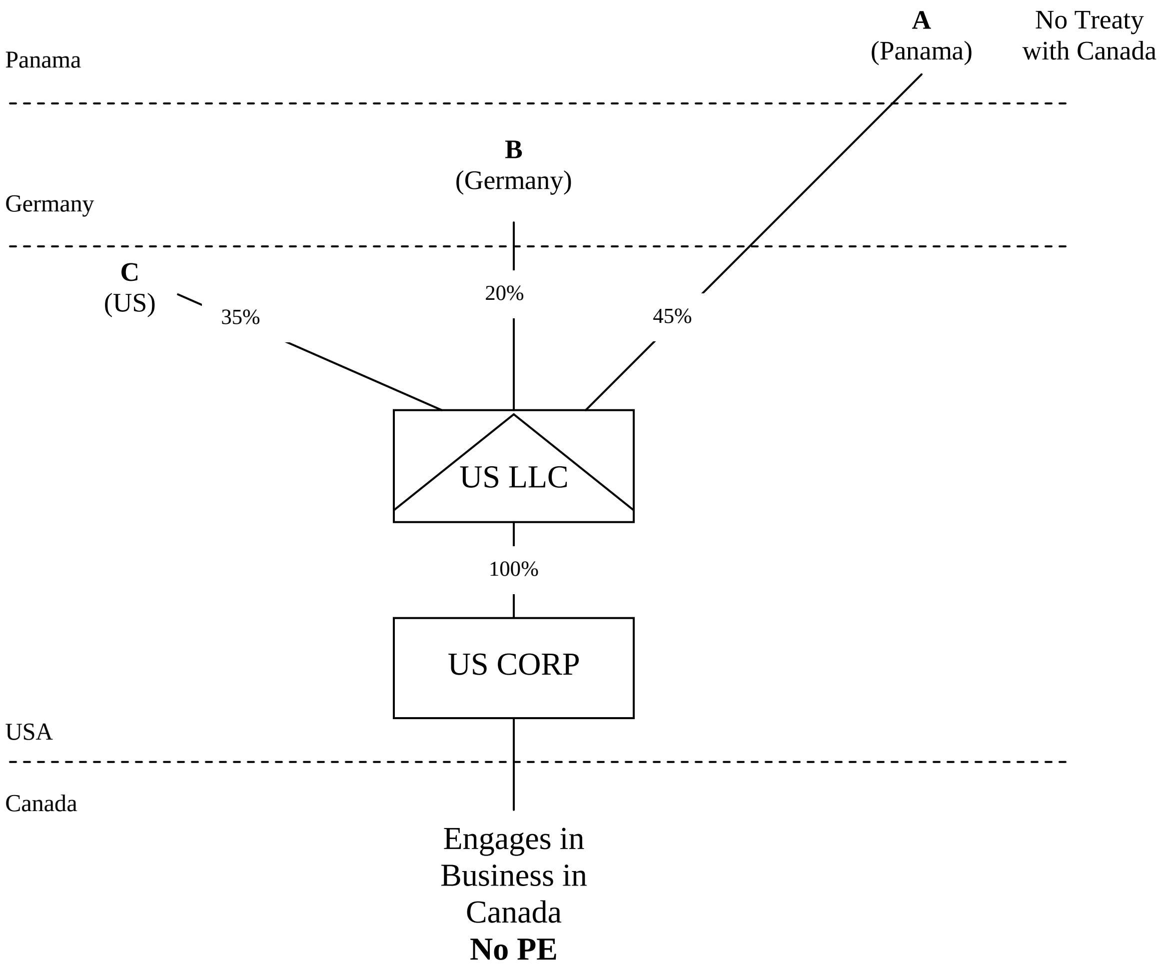
Compare the example above to a situation where not all of the members of U.S. LLC are U.S. persons:



Here, as the U.S. corporation is not publicly traded, U.S. residents must own at least 50% of the shares representing voting rights and value of the corporation. In the above illustration, U.S. Corp would not qualify for Treaty benefits, and its Canadian source business profits would be subject to tax in Canada even in the absence of a permanent establishment. Thus, where investors include non-U.S. residents, careful consideration must be given to investment structures to ensure that Treaty benefits are not inadvertently denied to U.S. persons that could have benefited from the Treaty if another ownership arrangement had been used.

Each of the above examples illustrates the principles associated with Article IV, paragraph 6 of the Treaty. Treaty benefits and tax positions will be impacted by a taxpayer's specific situation and how the business structure is implemented. Careful consideration of all applicable factors should be considered before adopting or modifying a business structure.

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