Update On ULCs – Rising From The Ashes?

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The Fifth Protocol to the *Canada-United States Income Tax Convention* (the "Treaty") introduced an anti-hybrid rule that negatively impacted the continued use of Canadian Unlimited Liability Companies ("ULCs") by U.S. residents. However, recent statements by the Canada Revenue Agency (the "CRA") suggest that the new rule will not be interpreted as negatively as anticipated and paves the way for the continued use of ULCs in certain circumstances.

Background

A ULC is treated as an ordinary corporation for Canadian income tax purposes. However, a ULC owned by a U.S.-resident shareholder would typically "check the box" under U.S. rules so as to be a disregarded entity for U.S. tax purposes. This "hybrid" nature of the ULC proved useful for many U.S. residents wishing to acquire or invest in Canadian businesses in a tax-effective manner. The U.S. tax advantages of structuring such an investment through a ULC included (i) the ability to utilize losses incurred in the ULC against income of the U.S. parent, (ii) the ability to maximize foreign tax credits in certain circumstances, (iii) through appropriate steps, the ability to "step up" the cost of ULC assets for U.S. tax purposes and (iv) utilizing the ULC in certain "double-dip" financing structures.

While the use of a ULC could produce certain U.S. tax advantages, these structures would only be tax-effective if the rules permitted payments to flow from the ULC to its U.S. shareholders at Treaty-reduced rates of withholding tax (such as the 5% withholding tax on dividends). The anti-hybrid rule introduced in the Fifth Protocol to the Treaty could, on its face, deny the Treaty-reduced rates of withholding tax on amounts of income, profit or gain (such as dividends) paid by the ULC to a U.S. person. The denial would be on the basis that the U.S. tax treatment of the payment would be different than it would be if the ULC was not a hybrid entity. If Treaty relief is denied, the 25% statutory rate of Canadian non-resident withholding tax would apply, which would materially increase the Canadian tax on profits earned through a ULC. The additional withholding tax might not be recoverable by the U.S. shareholder through the foreign tax credit mechanism.

As the anti-hybrid rule comes into effect in 2010, many U.S. companies with Canadian ULCs have recently reconsidered their corporate structure in order to avoid the increased tax leakage.

Recent CRA Guidance

At a recent conference the CRA commented on a number of proposals that had been considered by tax advisors as a way of avoiding the negative impact of the anti-hybrid rule.

Partial Relief by Capitalizing Retained Earnings

The CRA commented on a two-step alternative to paying a dividend. The ULC would first capitalize its retained earnings, resulting in an increase to the stated (and paid-up) capital of its shares. Next, the ULC would return capital to the U.S. shareholder, up to the amount of the recently-increased stated (and paid-up) capital. The first step would trigger a deemed dividend for Canadian income tax purposes but would be disregarded for U.S. tax purposes, regardless of the hybrid nature of the ULC. The second step would not precipitate a deemed dividend.

Based on the fact that the U.S. tax treatment of the deemed dividend would be the same regardless of the hybrid nature of a ULC, the CRA stated that the deemed dividend would not be denied the Treaty-reduced rate of Canadian non-resident withholding tax. Further, the CRA stated that the domestic general anti-avoidance rule ("GAAR") would not normally apply where the ULC is used by a U.S. parent to carry on an active branch operation in Canada and the two-step process is used to continue to qualify for the Treaty-reduced 5% rate of Canadian non-resident withholding tax on the distribution of the ULC's after-tax earnings.

Restructuring Using Third-Country Intermediary

The CRA also commented on the strategy of interposing a third-country blocker entity, such as a Luxembourg Société à Responsabilitée Limitée ("Sarl"), between the ULC and the U.S. shareholder. As the ULC would pay dividends to the Sarl, a resident of Luxembourg, rather than the ultimate parent in the U.S., the intent would be to have the 5% rate of Canadian non-resident withholding tax under the Canada-Luxembourg treaty apply, rather than the Treaty and its anti-hybrid rules. The CRA stated that the 5% rate under the Canada-Luxembourg treaty would apply provided that the Sarl was the beneficial owner of the dividend. The CRA also stated that the GAAR should not apply.

Restructuring Interest Payments

The CRA considered the scenario in which the shares of a ULC are owned by a U.S.-resident corporation ("US Subco"), US Subco's shares are owned by another U.S.-resident corporation ("US Parent") and the ULC is indebted to US Subco. For U.S. purposes, the interest received by US Subco from the ULC would be treated differently than would the receipt of interest by US Subco from a non-transparent entity. Accordingly, for Canadian purposes, the anti-hybrid rule would apply and the interest would be subject to the domestic 25% rate of non-resident withholding tax rather than the Treaty-reduced rate.

The CRA commented on the strategy of restructuring the debt such that the interest would be payable to US Parent rather than US Subco. For U.S. purposes, the interest would be included in US Parent's income whether or not the ULC is a hybrid entity. Accordingly, the CRA stated that the anti-hybrid rule would not apply to deny the benefit of the Treaty. However, the CRA concluded by stating that the GAAR may apply if the ULC is part of a financing arrangement that results in, among other things, duplicated interest deductions or an internally generated interest deduction in one country without offsetting interest income in the other country.

Concluding Thoughts

These comments from the CRA are welcome news to taxpayers and their advisors. The comments suggest the drafting of the Treaty's anti-hybrid rules may have been overly broad and that the use of a ULC by a U.S.-resident parent corporation should not be considered abusive in many circumstances. More importantly, these comments provide guidance for the continued use of ULCs in appropriate circumstances without some of the negative tax consequences initially anticipated by taxpayers and their advisors.

Shareholders of ULCs should carefully review their circumstances to consider the best course of action. The approach of capitalizing retained earnings and/or restructuring intercompany financing may be a practical solutions for many ULCs in straightforward cross-border structures. However, such a transaction may invite a higher level of scrutiny where a ULC is used in financing structures that are considered abusive.

Lang Michener LLP has the experience to assist in devising the optimal structure.

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