December 4, 2009

# New Planning Opportunities for ULCs

The Canada Revenue Agency ("CRA") announced helpful administrative positions concerning the new rules under the Fifth Protocol to the Canada-US Income Tax Convention, 1980 which will come into effect on January 1, 2010[1]. The CRA "Round Table", held on November 24, 2009 as part of the Canadian Tax Foundation's annual conference, provided a forum for CRA to provide its views on a variety of issues, including planning alternatives to manage certain changes under the Fifth Protocol. While CRA reserves the right to challenge any planning that it considers to be abusive, and specifically referenced so-called "double-dip" financings, it has expressed the following views:

### *Payment of Dividends from a ULC*

CRA has approved a "two-step" planning approach to maintain the treaty-reduced withholding tax, normally 5%, on dividend payments after January 1, 2010 by a ULC carrying on business in Canada.

The procedure is as follows: (i) the ULC will first increase its paid-up capital which will create a deemed dividend for Canadian tax purposes but which is eligible for relief under the Treaty; and (ii) the ULC will then reduce its paid-up capital, a transaction that is not subject to Canadian withholding tax.

Provided that the deemed dividend on the first step is disregarded under US tax laws and would be similarly disregarded even if the ULC were not fiscally transparent, CRA agrees that Article IV(7)(b) of the Treaty would not apply to deny Treaty benefits. Due to changes made to the Nova Scotia Companies Act last year, this procedure will be available to most NSULCs with retained earnings or other funds from which dividends would normally be paid.

### *Other Payments from a ULC*

CRA commented on a situation where debt owed by a ULC to its US parent is rearranged so that the debt (and corresponding interest) is paid to ULC's US grandparent. For US tax purposes, the grandparent would be regarded as receiving interest from a Canadian branch of its US subsidiary and for Canadian tax purposes the interest would be treated as having been paid to the US grandparent from the ULC. CRA confirmed that so long as the interest is subject to the same treatment in the US in the hands of the US grandparent as it would be if the ULC were not "fiscally transparent", Article IV(7)(b) of the Treaty does not apply to disallow treaty benefits. This will allow many shareholders of ULCs to arrange their affairs to allow for payments of interest, royalties and other "non-dividend amounts" to be taxed at preferential rates and will retain benefits in many existing situations.

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1. As discussed in our Client Update of November 5, 2009, the Fifth Protocol to the Canada-US Income Tax Convention, 1980 introduced significant changes which may affect the use of most Nova Scotia unlimited companies and other entities commonly called ULCs.

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***Use of a non Canadian/US Intermediary***

CRA also commented on a situation where a Luxembourg S.á r.l. is inserted between a US shareholder and its ULC subsidiary. The intermediary would be considered to be resident in Luxembourg for Canadian tax purposes but disregarded for US tax purposes. CRA confirmed that the 5% withholding rate under the Canada-Luxembourg tax treaty would apply if the intermediary is the "beneficial owner" of the dividends. CRA has previously published its views on the meaning of "beneficial owner". We understand that similar structures involving entities resident in other countries with which Canada has a tax treaty (such as a Dutch co-op) may produce the same result.

***Conclusions***

CRA's administrative guidance on planning strategies to manage certain consequences of the anti-hybrid provisions of the Fifth Protocol is timely and of assistance in specific circumstances. Each structure involving ULCs as hybrid entities must be examined to determine whether or not these strategies can be implemented.

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