November 2009

Nova Scotia Unlimited Companies: An Update

Withholding tax and other issues under the Fifth Protocol

The Fifth Protocol to the Canada-US Tax Convention, 1980 introduced significant changes which may affect the use of most unlimited companies and other so-called ULCs. These new rules will come into effect on January 1, 2010. US investors currently using or considering using ULCs to structure their Canadian investments should consult with their professional advisors. It may be desirable to undertake transactions in 2009 that are currently subject to treaty-reduced withholding rates, such as the payment of dividends and interest.

The Fifth Protocol introduces a number of favourable changes for cross-border investors, such as the phased elimination of withholding tax on related-party interest payments and the extension of treaty benefits to Limited Liability Companies ("LLCs"). However, the Fifth Protocol unexpectedly included provisions which may adversely affect the use of "reverse hybrid" and "hybrid" entities, including ULCs. The Fifth Protocol unexpectedly denies treaty benefits to payments by a Canadian resident to a US resident if, under US tax law, the payment is treated differently than if it had been made by a fiscally regarded entity (typically a "corporation").

Under the Fifth Protocol, payments of cross-border dividends, royalty or related-party interest payments and certain management fees from a ULC to a US recipient in most circumstances will be subject to the full 25% Canadian withholding tax. Prior to the Fifth Protocol, ULCs were entitled to the same reduced withholding rates on cross-border payments and favourable capital gains treatment as any Canadian corporation. There is some doubt as to whether the new rules will affect treaty protection for capital gains realized on the sale of the shares of a ULC which would otherwise be treaty-protected.

Most tax commentators have suggested that the new rules are overbroad and unduly affect cross-border debt financing arrangements. There is still some hope that US and Canadian revenue authorities may reconsider their strict interpretations of these provisions prior to the January 1, 2010 implementation date although time is running out. Additionally, taxpayers should review any advance income tax rulings issued by CRA Rulings Directorate in the next few months on the application of the Fifth Protocol to ULCs.

It may also be possible to structure cross-border investments with ULCs by using a non-Canadian/US intermediary such as a Luxembourg S.a r.l. Investors contemplating such a structure should carefully consider how major reforms to US international tax rules announced by the US Treasury Department on May 11, 2009 in its so-called "Green Book" may apply. The Green Book includes a proposal limiting the ability of a foreign entity, such as a ULC, being treated as a flow-through entity for US tax purposes for tax years beginning after December 31, 2010. While most existing Canadian ULC structures should not be affected, the

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Green Book proposals, if enacted, may negatively affect structures that use a non-Canadian/US intermediary. Careful planning is required to ensure that the US and Canadian tax consequences are appropriate in the circumstances.

New Income Tax Regulation 400(2)(e.1)

A recent amendment to the provincial permanent establishment rules in the Canadian *Income Tax Regulations* may affect a select number of corporations that rely on the federal unabated corporate tax rate. New Regulation 400(2)(e.1) deems a corporation that does not otherwise have a permanent establishment in a province to have a permanent establishment in the place designated in its "incorporating documents" or "bylaws" as its head office or registered office. This amendment applies to the 2009 and subsequent taxation years.

Prior to this amendment, a Canadian corporation (including a ULC) without a permanent establishment in a province would pay tax at the unabated federal corporate tax rate of 29%. Canadian corporations deemed by Regulation 400(2)(e.1) to have a permanent establishment in a province will qualify for a 10% reduction in the federal rate but will be exposed to provincial taxation. This may result in additional tax liability.

Most Canadian corporations already have a permanent establishment in a province and will not be affected by Regulation 400(2)(e.1). Generally speaking, this amendment will only affect a select number of Canadian corporations with no fixed place of business in Canada and insufficient connection to any place to make that a "permanent establishment".

There is substantial doubt as to whether this amendment will apply to Nova Scotia ULCs ("NSULC's") or other companies incorporated in Nova Scotia. Under Nova Scotia law, the registered office of a Nova Scotia company is not designated in its incorporating documents or bylaws. In practice the location of the registered office is determined by an ordinary directors' resolution or by an officer of the company. The term "bylaws" itself is a concept foreign to the *Companies Act*.

Investors with NSULCs or other Nova Scotia companies may wish to consult with their professional advisors about whether Regulation 400(2)(e.1) could affect their particular circumstances.

Recent Amendments to the Nova Scotia *Companies Act*:

On June 1, 2008, significant amendments to the Nova Scotia *Companies Act* came into effect. A year later, these amendments have proven quite useful in making routine corporate procedures more efficient in Nova Scotia. The following are the principal changes that may affect the use or contemplated use of NSULCs:

- **Formation of NSULCs**: The new rules permit continuance from another jurisdiction directly as a NSULC without the need to amalgamate. Similarly, limited companies already in Nova Scotia can convert to NSULCs by a unanimous shareholder resolution.

- **Amalgamating without court approval**: While court-approved amalgamations are still available, amalgamations can now be implemented by a special shareholder resolution as long as solvency tests are met. Certain non-ULC companies are also now able to amalgamate without shareholder approval on a "short-form" basis.

- **Share capital rules**: New rules regarding share capital are the most significant substantive changes to the *Companies Act*. It is now possible to add paid-up capital without issuing additional shares by capitalizing surplus. The statutory recognition of the concept of capital accounts brings the *Companies Act* in line with other Canadian jurisdictions. Companies can also now authorize an unlimited number of shares.

- **Capital reductions**: Previously, limited companies required court approval to reduce their capital. Court approval is no longer necessary if the company can meet a solvency test. The common law rule permitting NSULCs to reduce capital by resolution has been statutorily codified with some clarifications.

- **Shareholder resolutions**: Previously, shareholder special resolutions (necessary for fundamental changes) required 3/4 of the votes present at a meeting followed by a bare majority at a second, confirmatory meeting. The amendments reduce this to a 2/3 majority and eliminate the confirmatory meeting. Existing companies will be bound by the 3/4 majority requirement (but not the need for a confirmatory meeting) unless they adopt the new threshold.

- **Location of corporate records**: Companies no longer need to keep their main share transfer register and other corporate records at their registered office (i.e., in Nova Scotia). It is still necessary for records to be accessible electronically from the registered office.

- **Modernizing financial assistance restrictions**: Previously, leveraged buyouts and some corporate reorganizations could not easily be done in Nova Scotia due to rules which prohibited Nova Scotia companies giving financial assistance to assist the purchase of their shares. The new rules expressly permit assistance to be given except where it would be oppressive to the interests of shareholders or creditors.

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