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FEATURED PERSPECTIVES

Is the Nova Scotia Unlimited Liability Company Dead?

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The adoption in 1997 of the check-the-box rules in the United States gave rise to the increased use by U.S. residents of hybrid entities that can elect flow-through tax treatment for U.S. purposes. In Canada this phenomenon spawned the resurrection of a moribund entity, the unlimited liability company (ULC), which became the single most popular vehicle for U.S. investors in Canada.

Now, two recent developments — one introduced by the fifth protocol to the Canada-U.S. tax treaty and one contained in a change to the regulations under the Income Tax Act (Canada) — could be seen as the death sentence of the Nova Scotia ULC (NSULC). This article considers the effect of these changes on the future of ULCs in general and NSULCs in particular as the preferred Canadian investment vehicle for U.S. residents.

Why Are ULCs Used?

The History of ULCs

The 1990s saw the advent in the United States of the limited liability company, an entity formed under the law of one of the U.S. states that is similar to a regular corporation. Initially, efforts were made to qualify LLCs as flow-through entities for purposes of U.S. domestic tax law under the preexisting U.S. case law and administrative practice.[1]

Then in 1997, the check-the-box rules were adopted in the United States, providing for a simple election as to whether an LLC or any other entity eligible for this regime[2] would be treated as either (1) a flow-through entity that is treated as a partnership (when there are two or more members) or is disregarded (when there is one member) or (2) a corporation.[3]

The adoption of the check-the-box rules in the United States was accompanied by a proliferation outside the United States of hybrid entities that are regular corporations in their home jurisdiction, but can elect flow-through tax treatment for U.S. purposes.[4] Lawyers in the province of Nova Scotia dusted off an antiquated piece of provincial legislation that provides for the creation of ULCs under Nova Scotia law. More recently, Alberta and then British Columbia amended their corporate statutes in 2005 and 2007, respectively, to also allow for the creation of ULCs.

For Canadian tax purposes a ULC is a regular corporation, but for U.S. tax purposes it is not a per se corporation and is given flow-through tax treatment.[5]

The Use for ULCs

Generally, from the standpoint of U.S. tax planning, the preferred strategy has been to elect flow-through

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[1]This required that an entity have fewer than three out of four of the following corporate characteristics:

- limited liability;
- free transferability of interests;
- unlimited life of the entity; and
- centralized management and control.

See Treas. reg. 301.7701-1, et seq. as they read at that time.

[2]Generally, all entities are eligible except per se corporations.

[3]*See* IRC sections 7701(a)(2) and (3) and Treas. reg. section 301.7701-1 through -3.

[4]A hybrid entity is an entity that for tax purposes is treated as a flow-through entity (that is, it is either disregarded or treated as a partnership) in one country, but is treated as a corporation in the other country.

[5]This is so for ULCs formed under Alberta, British Columbia, or Nova Scotia law, unless the ULC checks the box.

status for U.S.-owned business vehicles, whether U.S.-formed or foreign. The traditional benefit of this choice has been to avoid classical corporate-shareholder double taxation on distributed profits of an association taxable in the United States as a corporation. This benefit was substantially reduced when the United States adopted a 15 percent tax for U.S. individual taxpayers on U.S. (and some other, including Canadian) corporate dividends. However, a sunset on this relief, scheduled for December 31, 2010 (which would, if not extended, terminate this special rate), still makes it generally desirable to choose flow-through treatment. Separately, President Obama's February 26, 2009, budget proposed to increase this rate to 20 percent.

In addition to the base strategy of avoiding double taxation, the use of flow-through hybrid entities in the international context has provided U.S. parties with opportunities to reduce overall group taxes. This is seen in the way U.S. multinational enterprises have been financing and structuring their controlled foreign affiliates.[6]

The First Blow: The Fifth Protocol

Overview

On September 21, 2007, Canada and the United States signed the fifth protocol to the Canada-U.S. treaty, and it came into force on December 15, 2008.[7]

The protocol adds new Article IV(7) to the treaty. Paragraph (b) of this provision denies treaty benefits by deeming an amount of income, profit, or gain not to be paid to (that is, the provision treats an amount that, in fact, has been paid as though it had not been paid) or derived by a person who is a resident of a contracting state where two factors exist. The person is considered under the tax laws of the source state to have received the amount from an entity that is a resident of that state. By reason of the entity being treated as fiscally transparent under the law of the residence state, the treatment of the amount under the taxation law of the residence state is not the same as its treatment would be if that entity were not treated as fiscally transparent under the law of that state.[8]

Article IV(7) is scheduled to come into effect on the first day of the third calendar year that ends after the protocol enters into force — that is, on January 1, 2010.

The Effect of Article IV(7)(b) on ULCs

The overbroad scope of Article IV(7)(b) came as a surprise to Canadian and U.S. tax observers.[9] Under this provision, issues arise for U.S. shareholders of Canadian ULCs, organized under the laws of Alberta, British Columbia, or Nova Scotia, that are treated as fiscally transparent in the United States. Under the new rule in Article IV(7)(b), effective after 2009, treaty benefits would be denied to U.S. residents regarding payments made by the ULC. Therefore, amounts such as interest, royalties, and dividends paid by a ULC will not qualify for the reduced withholding tax under the treaty and will be subject to Canada's domestic withholding rate of 25 percent.

That result, regarding dividends, was not only unexpected, but as shown below, is unwarranted. That is because under the protocol, the overall Canadian tax on amounts derived by a U.S. resident through a ULC would be significantly higher than the tax levied if the U.S. resident obtained the amounts either directly or through an interposed regular corporation that is not fiscally transparent under the laws of either Canada or the United States.

The base case scenario is that of a regular U.S. subchapter C corporation that carries on business in Canada through a permanent establishment. The U.S. corporation pays approximately 30 percent mainstream Canadian federal and provincial taxes and a 3.5 percent branch profits tax (5 percent on the 70 percent after-tax distributable profits under Article X), for a total of 33.5 percent. The corporation pays little additional U.S. tax, as the 35 percent U.S. corporate tax is almost totally offset by the Canadian taxes of 33.5 percent.

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[6]In some cases, however, the enactment in 2006, with a sunset, of IRC section 954(c)(6) obviated the need to use hybrid entities to achieve financing-related group benefits.

[7]For a detailed analysis of the fifth protocol, see N. Boidman and M. Kandev, ''Fifth Protocol to the Canada-United States Tax Treaty,'' (2008) 62(3) *Bulletin for International Taxation*, 101.

[8]Separately, Article IV(7)(a) denies treaty benefits by deeming an amount of income, profit, or gain not to be paid to or derived by a person who is a resident of a contracting state where the person is considered under the tax laws of the source state to have derived the amount through an entity that is not a resident of the person's residence state, but by reason of the entity not

(Footnote continued in next column.)

being treated as fiscally transparent under the law of the residence state, the treatment of the amount under the tax law of the residence state is not the same as its treatment would be if that amount had been derived directly by the person.

[9]Paragraph (a) of Article IV(7), however, was not unexpected, as it attacks a familiar financing structure that allows U.S.-based multinationals with Canadian operating subsidiaries to minimize taxes by financing the subsidiaries through Canadian partnerships that have checked the box to be treated as corporations in the United States. This structure permits the immediate deduction of interest in Canada without an immediate corresponding recognition of the amount in the United States. It is similar to a structure that Canadian-based multinationals used to finance U.S. operating subsidiaries before the 1997 enactment of IRC section 894(c). Separately, the addition of Article IV(6) was a welcome and long-awaited change. This provision addresses the fact that LLCs and their U.S. members are currently ineligible for benefits under the treaty.

The result is the same if the U.S. corporation mentioned above instead carries on its business through a Canadian corporation other than a ULC. The U.S. taxpayer then pays, on distributed profits, the same 33.5 percent Canadian taxes, except that the 3.5 percent addition to the mainstream taxes comes from the withholding tax on dividends, not the branch profits tax. In the United States, the result will be the same as in the base scenario (IRC section 902). The results in the two scenarios above are not changed by the protocol.

If the U.S. corporation instead uses a ULC that does not check the box (meaning the ULC is disregarded for U.S. purposes), in Canada the tax results under the current treaty are the same as above. However, under new Article 1V(7)(b), effective after 2009, the U.S. parent will be denied the treaty reduction (to 5 percent) of the withholding tax on dividends from Canada's 25 percent statutory rate. Therefore, the U.S. corporation will pay a 25 percent withholding tax on a distribution of all the ULC's after-tax profits, or 17.5 percent, for an aggregate Canadian tax rate of 47.5 percent instead of the 33.5 percent tax that would be paid in all other cases.

The above outcome may not have been intended by the treaty negotiators, as discussed in the following section.

Avoiding the Blow

Since the blow to ULCs provided by Article IV(7)(b) is scheduled to hit on January 1, 2010, Canadian and U.S. tax practitioners are hoping it never materializes. There would appear to be some basis for those hopes. In its report on the fifth protocol, released on September 11, 2008, the U.S. Senate Committee on Foreign Relations states that this provision is ''potentially overbroad'' and urges the Treasury Department to address the issue with Canada as soon as possible. The Canadian Department of Finance has also accepted that Article IV(7)(b), as drafted, is probably inappropriate.[10]

Should the consequences of the surprise attack on Canadian ULCs in the protocol materialize, they will likely result in the increased use by U.S. investors of middle-tier hybrid entities in third jurisdictions.[11] One situation that will likely become frequent, considering new Article IV(7)(b), involves the interposition of a Luxembourg *société à responsibilité limitée* (SARL), an entity that is treated as a corporation in Canada and Luxembourg, but that may elect to be disregarded for U.S. tax purposes. In a triangular situation involving a ULC and SARL owned by a U.S. resident investor, the Canada-Luxembourg tax treaty would be applicable, as the SARL is a resident of Luxembourg under that treaty. Therefore, Canada's withholding tax on dividends from the ULC to the SARL will be reduced to the 5 percent rate available under the Canada-Luxembourg tax treaty. The treaty will not apply in this situation, and new Article IV(7)(b) will not deny the reduction in withholding tax, as Canada will not consider the U.S. shareholder of the SARL to have received dividends from the ULC.[12]

The Second Blow: Canada's PE Regs

Overview

Without fanfare, the Canadian government has included in the massive 2009 budget bill[13] that was tabled before Parliament on February 6, 2009, an obscure amendment to the regulations under the Income Tax Act with far-reaching consequences that may increase the provincial component of the tax burden of some U.S.-owned NSULCs by 60 percent and their overall tax bill by 20 percent.

Background

Under the Canadian Constitution, both the federal government and the provinces may levy income tax. The federal government does so under the Income Tax Act. Although all provinces have their own corporate tax statutes, all except Alberta and Quebec (and before 2009, Ontario) have integrated their system with the Income Tax Act.

Under subsection 123(1) of the Income Tax Act, corporations are taxable at the posted federal rate of

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[10]This is based on statements made during the presentation of senior Department of Finance officials at the 2007 annual conference of the Canadian Tax Foundation.

[11]Any such self-help treaty shopping would seem to be accommodated by the two recent Canadian court decisions on point in *Prévost Car Inc. v. Canada*, 2009 D.T.C. 5053 *aff'g* 2008 D.T.C. 3080 (T.C.C.), and *MIL (Investments) S.A. v. Her Majesty the Queen,* 2006 D.T.C. 3307 (T.C.C) *aff'd* 2007 D.T.C. 5437 (F.C.A.). *See* N. Boidman and M. Kandev, ''Canadian Taxpayer Wins *Prévost* Appeal,'' *Tax Notes Int'l*, Mar. 9, 2009, p. 862. This is also consistent with the conclusions of the Advisory Panel on Canada's System of International Taxation, which in its final report issued last December, stated, in recommending that there be no additional initiatives against treaty shopping: ''The Panel believes that businesses should be able to organize their affairs to obtain access to treaty benefits.'' ''Enhancing Canada's International Tax Advantage: Final Report,'' Advisory Panel on Canada's System of International Taxation, Dec. 2008, *available at* http://www.apcsit-gcrcfi.ca at para. 5.68. *See also* Nathan Boidman, ''Reforming Canada's International Tax Regime: Final Recommendations, Part 1,'' *Tax Notes Int'l*, Jan. 19, 2009, p. 247, *Doc 2009-79*, or *2009 WTD 12-16*; and Nathan Boidman, ''Reforming Canada's International Tax Regime: Final Recommendations, Part 2,'' *Tax Notes Int'l*, Jan. 26, 2009, p. 345, *Doc 2009-84*, or *2009 WTD 15-11*.

(Footnote continued in next column.)

[12]This was confirmed by Department of Finance officials at the 2007 annual conference of the Canadian Tax Foundation.

[13]Enacted on March 12, 2009, as an act to implement certain provisions of the budget tabled in Parliament on January 27, 2009, and related fiscal measures, S.C. 2009, c. 2.

38 percent on their taxable income or taxable income earned in Canada. The federal tax is integrated with the provincial corporate taxes, imposed at rates ranging from 10 percent to 16 percent, under subsection 124(1), which allows a deduction — known as an abatement — of 10 percent of the corporation's taxable income earned in the year in a province.[14] Whether a corporation has such income is determined under Part IV of the regulations. This determination is a matter of whether the corporation has a PE in one or several Canadian provinces. Regulation 400(2) defines a PE mainly as a fixed place of business. In essence, under the current rules, the 10 percent abatement is allowed only to corporations that have sufficient business nexus to one or more provinces under the federal regulations. Correspondingly, all provinces, except Alberta and Quebec, use the same criterion to establish whether a corporation is liable for corporate tax within a province. Alberta and Quebec have their own rules, which are substantially, but not entirely, identical to the federal PE regulations.

The Proposed Change

Clause 91 of Part 1 of the budget bill now proposes to add new paragraph (e.1) to the PE definition in Regulation 400(2) effective for the 2009 and subsequent tax years. This proposal jettisons a pillar of Canada's corporate tax system — the requirement that for there to be a PE, there must be a business being carried on — by providing that:

> if, but for this paragraph, a corporation would not have a permanent establishment, the corporation is deemed to have a permanent establishment at the place designated in its incorporating documents or bylaws as its head office or registered office.

This amendment to Regulation 400(2) significantly changes the interaction between the Income Tax Act and the corporate tax systems of the provinces, because new paragraph (e.1) operates a shift of tax revenues levied on passive corporations from the federal government to the provinces.[15] This amendment also operates (and was likely intended) to resolve some double tax issues that now exist. For example, Alberta has a rule, similar to the one in proposed new Regulation 400(2)(e.1), that as a last resort deems a PE ''in the place where it has its registered office or in a place designated in its articles, charter or by-laws as its office or registered office.'' The double tax could arise because in some cases the 10 percent abatement would not be available, while under the Alberta Corporate Tax Act the corporation would be liable for Alberta corporate tax.

Effect of the Changes on NSULCs

The general effect of the proposed change will be that under section 124 of the Income Tax Act, every corporation formed in Canada — whether or not it actually carries on a business in any province — will be entitled to the abated (that is, reduced by 10 percent) corporate tax rate and, for corporations formed under the law of those provinces that piggyback the federal corporate tax system (all but Quebec and Alberta), will be subject to provincial taxation. This change will not affect corporations, including ULCs, carrying on business through a traditional PE, but will directly affect corporations that serve as a holding company or own few passive investments. This is because, subject to uncertainties arising out of factual matters and the rebuttable presumption that a corporation has a business, holding corporations would generally not be seen to have a PE under Regulation 400(2) absent new paragraph (e.1).

In this respect, new Regulation 400(2)(e.1) is another blow to NSULCs, as it may significantly increase the tax burden on some U.S.-owned holding structures. Under the current rules, an NSULC that is a completely passive investment-holding corporation would not have a PE in Nova Scotia under Regulation 400 and hence would be taxable only at the unabated federal rate (29 percent in 2009). Under the new rules, the NSULC will be subject to the combined Nova Scotia-federal rate (35 percent in 2009)[16] — that is, a 60 percent increase in the provincial element of its tax burden and a 20 percent raise on its total tax bill.

Avoiding the Blow

Moving to a Lower-Tax Province

An obvious way for affected investors using NSULCs for their Canadian ventures to deal with the change in the PE regulations is to ''move'' the NSULC to a lower tax province. The Nova Scotia Companies Act allows for export continuance, while most other Canadian corporate legislations provide for import continuance.[17] Such continuance should not be a taxable event either in Canada or in the United States.

Moving while preserving ULC status. Currently the obvious choice is for an NSULC to move to Alberta. If preserving ULC status is still desirable, in light of new Article IV(7)(b) of the treaty, this would allow the

[14]Further reduction is then applied under section 123.4, which brings the current federal general corporate rate to 19 percent.

[15]In the case of Ontario, the new rule preserves Ontario's tax revenues. This may explain why the federal government first committed to make this amendment in the 2006 Canada-Ontario Memorandum of Agreement Concerning a Single Administration of Ontario Corporate Tax.

[16]Nova Scotia has the highest provincial corporate tax rate in Canada.

[17]The Canada Business Corporations Act and the corporate statutes of Alberta, British Columbia, Manitoba, New Brunswick, Newfoundland, Nova Scotia, Ontario, Saskatchewan, and Yukon.

former NSULC to remain tax transparent from a U.S. perspective as a ULC under the legislation of Alberta, while receiving the lowest provincial corporate tax rate in Canada, currently 10 percent.

Another alternative would be for the NSULC to continue under the ULC legislation of British Columbia, where the corporate tax is currently 11 percent, but is scheduled to be reduced to 10 percent effective January 1, 2011.

Moving while abandoning ULC status. If ULC status is no longer desirable in light of the changes to the treaty, better alternatives may soon materialize, as the amendment to Regulation 400(2) may increase corporate tax competition between Canadian provinces. On March 17, New Brunswick announced that it will phase in an 8 percent corporate tax rate by 2012 (12 percent in 2009, 11 percent in 2010, 10 percent in 2011, and 8 percent in 2012). This clearly would make it the prime holding company location in Canada from a tax rate standpoint. However, until 2012, given that there is no Canadian province with a corporate rate under the abatement rate of 10 percent, for those corporations formed in a co-opted province, there appears to be no potential favorable arbitrage arising from the change to the regulations. (See *Doc 2009-5989* or *2009 WTD 53-17*.)

However, there may be an interesting planning opportunity that has been created by the amendment to Regulation 400. Quebec does not piggyback the federal system and has no deemed PE rule of the type now being proposed under Regulation 400(2)(e.1). Thus, this change could give rise to an overall tax reduction for Quebec-formed companies that do not carry on business and have no PE for Quebec tax purposes. Such a corporation would, under the new rule, be entitled to the abated federal rate of corporate tax without paying tax to any province. The question arises, however, whether a structure using such a Quebec corporation would not be seen to give rise to abusive tax avoidance by the Quebec government.[18]

Benefits of a midyear move? Finally, moving an existing NSULC to another province in midyear seems to give rise to a probably unintended one-year tax holiday under the amended regulations. When a corporation has a PE in only one province, the force of attraction rule in Regulation 402(1) provides that the whole of the corporation's taxable income for the year is deemed to have been earned in that province. However, Regulation 402(3) applies ''where, in a taxation year, a corporation had a permanent establishment in a province and a permanent establishment outside that province.'' This seems to mean that a company that moves in midyear would have in a tax year a PE both in its province of origin and in the province of continuance (although not at the same time). The potential one-year tax holiday arises from the application of the taxable income allocation formula under Regulation 402(3). Assuming the company has no salary and wages (because it has no employees), the only criterion for allocation would be ''gross revenue for the year reasonably attributable to the permanent establishment in the province.'' Since the company would be completely passive, it should not be reasonable to attribute any gross revenue to any province. Hence, if that is correct, Regulation 402 would attribute nil taxable income to both the province of origin and the province of continuance, and provincial tax would thus be avoided for a year (presumably the application of Regulation 402(1) would resume in the subsequent year).

Establishing a PE in a Lower-Tax Province

A potentially simpler way to avoid the blow to NSULCs coming from the change to the regulations is to simply have the NSULC establish a PE in a low-tax province, such as Alberta, and hence preempt the application of the new last-resort deemed PE rule.

One way to achieve that objective is for the affected NSULC to acquire units in a public limited partnership carrying on a business in Alberta. In this respect, holding even a limited partnership interest in a partnership should give rise to a PE for the partner.[19]

Conclusion: Is the NSULC Dead?

The recent changes to the treaty and the regulations under the act seem to have compromised the future of NSULCs as the preferred business vehicle for U.S. residents investing in Canada. As discussed above, there are ways to avoid the blows to NSULCs and maintain a structure using such entities. It seems the NSULC is on life support but has not yet expired. Two hoped-for changes would improve the chances of survival of NSULCs. One is an amending protocol between Canada and the United States to repeal or significantly restrict new Article IV(7)(b) of the treaty; the other is a tax rate change by the Nova Scotia government reducing its corporate tax rate at least down to the abatement level of 10 percent. Time will tell whether and when these will happen. In the interim, U.S. investors in Canada will need to reexamine their arrangements to determine their alternatives. ◆

[18]On January 30, 2009, the Quebec government launched consultations on aggressive tax planning with the objective of strengthening Quebec's antiavoidance measures. *See* M. Kandev, ''Quebec Putting the Screws on Aggressive Tax Planning,'' CCH *Tax Topics*, No. 1927 (Feb. 12, 2009) 1; and CCH *Quebec Tax Reporter*, No. 558 (Feb. 2009) 1.

[19]The decisions in *The Queen v. Robinson Trust et al.*, 98 D.T.C. 6065 (F.C.A.), and *Grocott v. The Queen*, 96 D.T.C. 1025 (T.C.C.), stand for the proposition that all partners, including limited partners, of a limited partnership carry on the business of the partnership, even though the limited partners took no part in the management of the business.