

New Protocol to the Canada-US Tax Treaty: Recognition of LLCs and Elimination of Treaty Benefits for Certain Hybrid Entities

On September 21, 2007, Canada and the United States signed the long-awaited Fifth Protocol (the “**Protocol**”) to the Canada-US Income Tax Convention (the “**Treaty**”). Consistent with the announcement made in the 2007 Federal Budget, the Protocol generally extends the entitlement to claim Treaty benefits to certain fiscally transparent entities, such as US limited liability companies (“**US LLCs**”). At the same time, the Protocol clarifies that certain hybrid entities will be denied benefits under certain circumstances. As a result of these changes, the tax treatment of existing and contemplated cross-border structures will need to be carefully reviewed.

US LLCs

US LLCs are routinely utilized as business vehicles on account of their favourable US tax treatment and the limited liability protection afforded to their members. In contrast to conventional “C corporations”, US LLCs are not generally subject to tax at the entity level. Rather, the profits and losses of a US LLC “pass-through” to its members, in a manner similar to the operation of a partnership.

However, in the cross-border context, US LLCs historically have not been the optimal entity to be used by investors wishing to make investments in Canada. According to the Canada Revenue Agency (the “**CRA**”), US LLCs that are treated as fiscally transparent for US income tax purposes do not qualify as “residents” of the US for purposes of the Treaty, with the result that Treaty benefits may not generally be claimed by such companies.¹ As a result, a US LLC would generally be subject to withholding tax at the statutory rate of 25% on payments of interest, dividends and royalties received from a Canadian payor.

The Protocol extends Treaty benefits to US LLCs by amending the residence provision (Article IV) of the Treaty. In simplified terms, the Protocol provides that a US resident earning income through an entity that is considered to be fiscally transparent for US tax purposes, such as an LLC, will generally be entitled to claim the benefits of the Treaty where the US treatment of the income derived through the entity is the same as it would have been had the income been derived directly by the US resident.

The Protocol also clarifies which Treaty-reduced rate of withholding tax will apply to dividends earned by investors through US LLCs and other fiscally transparent entities (such as partnerships). Currently, the Treaty provides for a reduced rate of withholding tax of 5% on dividends paid by a Canadian company to a US company that is the beneficial owner of at least 10% of the US company’s voting stock. (A reduced

¹ While US LLCs may technically qualify to claim Treaty benefits by electing to be treated as corporations under US law, this would eliminate access to the tax benefits which may have been the motivation for utilizing a US LLC in the first instance.

withholding tax rate of 15% generally applies to dividends paid by a Canadian company to all other US residents.) The CRA has historically taken the position that taxpayers were not entitled to “look through” a partnership to determine the size of a company’s shareholding for the purpose of determining the applicable Treaty-reduced rate of dividend withholding tax.² Thus, the CRA was of the view that even if all of the shares of a Canadian corporation were held by a US partnership, the members of which were all US resident companies that each held more than a 10% interest in the partnership, the applicable Treaty-reduced rate of withholding tax on dividends received from the Canadian corporation was still 15%, and not 5%.

The Protocol provides that shares held by a fiscally transparent entity (such as a partnership and certain US LLCs) will be considered to be held by a corporate member of the LLC or corporate partner of the partnership, as applicable, in proportion to that member’s/partner’s ownership interest in the relevant LLC or partnership. As a result, US resident companies that own at least 10% of the shares of a Canadian-resident corporation through a US LLC or partnership will generally be entitled to access the 5% dividend withholding rate provided under the Treaty.

In respect of taxes withheld at source, the Treaty amendments introduced by the Protocol will become operative on the first day of the second month that begins after the Protocol enters into force. For the purposes of other taxes, the amendments will generally take effect in respect of taxation years that begin after the calendar year in which the Protocol enters into force.

Loss of Treaty Benefits for Certain Hybrid Entities

The Protocol also introduces further additions to the residence article of the Treaty that will effectively provide that certain hybrid entities will no longer be entitled to claim the benefits of the Treaty. These new Treaty residence provisions are presumably targeted

at perceived abuses that result from the differing tax treatment of hybrid entities under the Canadian and US tax systems.

Of particular significance, under the terms of the Protocol, US resident shareholders of a Canadian unlimited liability company formed under the laws of the province of Nova Scotia or Alberta (a “**ULC**”), which “checks-the-box” to be treated as a disregarded entity for US tax purposes, will generally not be entitled to claim the benefits of the Treaty in respect of amounts paid to, or derived by, the US shareholders from the ULC (such as interest and dividends). Accordingly, the general statutory rate of withholding tax (i.e., 25%) will be exigible in respect of such payments.

Similarly, where a US resident derives an amount through a Canadian partnership and, by reason of the partnership not being treated as fiscally transparent under the laws of the US, the US tax treatment of the amount is not the same as it would have been if it had been derived directly by the US resident, the US resident will not be entitled to claim the benefits of the Treaty in respect of the amount. The practical result of this new rule will be to preclude US residents from claiming the Treaty-reduced rates of Canadian withholding tax previously available in respect of payments made in connection with certain “reverse hybrid” structures that have been used by US residents to lend amounts into Canada.

A host of arrangements, including the so-called “tower” financing structures, may be negatively impacted by the new rules contained in the Protocol relating to hybrid entities. Accordingly, all taxpayers that conduct business through, or receive payments from, entities that are characterized differently for Canadian and US tax purposes will be well advised to consider the implications of the Protocol.

The new hybrid entity amendments will become operative on the first day of the third calendar year that ends after the Protocol enters into force. As a consequence, the earliest date on which these amendments may become effective is January 1, 2010.

² The CRA’s longstanding position has been that US corporate partners of a partnership are not entitled to access the reduced dividend withholding tax rate because it is the partnership, not the partners, that own the shares of the corporation.

A Cautionary Note

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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