TAX-EFFICIENT STRUCTURING IN CANADA: CHOICE OF ENTITY CONSIDERATIONS AND THE EXPANDING DYNAMIC OF THE UNLIMITED LIABILITY COMPANY

By Michael W. Domanski, Todd A. Miller, Michael F. Friedman & Wayne D. Gray

Background

When a U.S. tax practitioner is representing a client in the process of starting a business in Canada, an immediate question should come to mind – "what type of entity should be used?" As is typically the case in tax planning matters, the answer to this question will depend on both tax and non-tax considerations, including the projected life of the Canadian investment (and, thus, whether the deferral of U.S. taxes[1] on the Canadian earnings of the chosen entity would be meaningful) and whether the U.S. taxpayer is an individual, a pass-through entity (*e.g.*, a partnership) or a corporation for U.S. tax purposes. The type of entity selected could have negative U.S. and Canadian consequences for the taxpayer and, as a result, a Canadian investment vehicle should not be chosen in haste. This article will first outline the U.S. tax issues to be considered in this context and will subsequently focus on one of the more popular entities used in U.S. – Canadian transactions, the Nova Scotia or Alberta unlimited liability company ("ULC").

U.S. Tax Fundamentals

In General. While a U.S. investor can undertake its Canadian business through a variety of entities (*i.e.*, a corporation, partnership, or ULC, or non-entity / branch), the essential U.S. tax issue generally revolves around whether the objective of the chosen tax structure is to defer the payment of U.S. taxes on the Canadian earnings of the chosen entity (and keep the earnings offshore) or to pass-through such earnings, and the associated Canadian taxes (as a foreign tax credit), directly to the ultimate owner(s). If the former "deferral" approach is preferred (since, for example, it could deliver "significant time value of money" benefits), the U.S. investor would need the Canadian entity to be treated as a corporation for U.S. tax purposes. Under the U.S. entity classification tax rules (commonly known as the "Check-the-Box" regulations), a Canadian corporation is considered a "per se" corporation, but the general "default" status of a Canadian partnership or ULC is that of a "pass-through" entity. As a result, in respect of either a Canadian partnership or a ULC, an Internal Revenue Service Form 8832 must be executed to elect corporate treatment. If a pass-through structure is more advantageous (*e.g.*, to eliminate the second layer of corporate tax on the distribution of the underlying Canadian earnings of the chosen entity to the individual owners), a partnership, ULC, or branch could be selected.

Deferral Structures. Before implementing a deferral structure in which the Canadian operational entity is treated as a corporation for U.S. tax purposes, a U.S. investor should be mindful that true deferral is only achieved to the extent that the local effective tax rate on the Canadian earnings is less than the U.S. effective tax rate. Since the Canadian tax regime is often more burdensome than the U.S. tax system, and the U.S. tax rules generally provide a foreign tax credit for foreign taxes paid on offshore earnings, a U.S. taxpayer may not necessarily incur any residual U.S. tax if the Canadian earnings were repatriated. Moreover, if a U.S. individual or pass-through entity is the owner of the Canadian entity in this context, the U.S. taxpayer will be ineligible to receive a foreign tax credit in the U.S. for the Canadian income taxes paid at the Canadian entity level (the U.S. "indirect" foreign tax credit attributable to the taxes "deemed" to have been paid in Canada are only available to U.S. corporate taxpayers).[2] Finally, the Internal Revenue Code contains a complex array of anti-deferral rules that aim to immediately include as taxable income certain foreign earnings which have remained offshore. Two of these regimes, those related to foreign personal holding companies and foreign investment companies, were recently repealed by the American Jobs Creation Act of 2004. However, the more comprehensive Subpart F / controlled foreign corporation and passive foreign investment company rules still remain and generally apply to structures involving less active portfolio investment-type transactions. Therefore, it is a possible that the earnings of the Canadian entity will be required to be included on the U.S. tax return of the U.S. investor even if they are re-invested offshore.[3]

Pass-Through Structures. There are two primary advantages to structuring a Canadian entity as a pass-through entity for U.S. tax purposes: (1) the possibility of offsetting U.S. income with the losses of the Canadian operation; and (2) for individual and pass-through owners, the possibility of obtaining a U.S. foreign tax credit for the income taxes paid by the Canadian company. These advantages are frequently much more meaningful to U.S. taxpayers than the potential deferral benefit, especially in light of the complex web of U.S. anti-deferral rules that are often difficult to defeat. It should be noted, however, that pass-through structures are not free from their own U.S. tax complications. For example, U.S. taxpayers should monitor the application of the U.S. dual consolidated loss ("DCL")[4] and overall foreign loss ("OFL")[5] rules that can either disallow the application of Canadian losses or income taxes to otherwise reduce U.S. tax liabilities. Moreover, since the broad architecture of the U.S. foreign tax credit regime generally places a limit on available foreign tax credits by reference to the U.S. taxpayer's foreign source income amount, the U.S. foreign tax credit regime incorporates other mechanisms (*e.g.*, interest expense allocations) that aim to reduce the U.S. taxpayer's foreign source income. As a result, the net benefit of a pass-through structure may vary depending on the U.S. investor's global tax position.

THE UNIQUE CROSS-BORDER ROLE OF THE CANADIAN ULC

The Origin of the ULC as a Tax Planning Device. When U.S. tax deferral is sought and U.S. tax treatment of the Canadian entity as a corporation is imperative, a Canadian corporation is generally a suitable entity. However, in pass-through structures or situations where a more "exotic" vehicle is desired, a ULC may be the preferred entity. Prior to 2005, the availability of a Canadian ULC was restricted to the Nova Scotia ULC ("NSULC") since the NSULC was historically the only ULC that could be formed under Canadian law.

For many years, NSULCs were simply regarded as an archaic relic of the old United Kingdom Companies Act.[6] However, in the early 1990s, U.S. tax practitioners realized that by structuring cross-border investments in Canada through an NSULC, U.S.-resident investors could simultaneously enjoy the Canadian advantages of investing through a Canadian-resident corporation, while retaining many of the foreign tax-related benefits that would typically only arise if they had chosen to directly invest or conduct business in Canada.

The potential benefits afforded by the use of an NSULC stem from the fact that NSULCs are treated as corporations for Canadian tax purposes (and taxed in the same manner as any other Canadian corporation),[7] yet may be treated as pass-through entities for U.S. tax purposes according to the "Check-the-Box" regulations. As a result, U.S.-resident investors that hold their Canadian investments through an NSULC may generally elect to consolidate the profits and losses (including start-up losses) of their Canadian operations with those of the other members of their corporate group when computing their U.S. tax liabilities, while preserving many of the benefits associated with maintaining a separate corporate existence in Canada. Moreover, as noted above, non-corporate U.S. taxpayers can achieve U.S. foreign tax credit benefits through the use of an NSULC. If a U.S. individual or pass-through entity owns a Canadian entity that is treated as a corporation for U.S. federal tax purposes and this entity pays income taxes on its non-U.S. earnings, the U.S. taxpayer will be ineligible to receive a foreign tax credit in the U.S. for those foreign taxes paid.[8] However, if that same U.S. taxpayer established its Canadian company in the form of an NSULC and did not "check-the-box" to treat the company as a corporation for U.S. federal income tax purposes, a U.S. foreign tax credit would be available since the Canadian income taxes would pass-through to the U.S. taxpayer, along with the Canadian earnings that would be subject to U.S. federal income tax.

The End of the Nova Scotia Monopoly. In May 17, 2005, the Province of Alberta amended its Business Corporations Act (the "ABCA") to permit the formation of Alberta unlimited liability corporations ("ABULCs").

The new Alberta corporate law regime, as it relates to the formation of ABULCs, differs significantly from that found in Nova Scotia. In contrast to the Nova Scotia Companies Act (the "NSCA"), the ABCA is a modern corporate statute that is superior to the NSCA in a number of key respects. For instance, the ABCA contains streamlined rules governing corporate reorganizations and imposes significantly lower filing fees on incorporations. (The fee for forming an ABULC is currently only CAN$100. By comparison, the cost of incorporating an NSULC is CAN$6,000. NSULCs are also required to pay an annual registration fee of CAN$2,000.)

Nevertheless, the new ABULC legislation potentially has its drawbacks -most notably, the liability of shareholders of an ABULC for the debts and obligations of the corporation is broader than the liability imposed on comparable shareholders of an NSULC.[9] (For a comprehensive comparison of the attributes of NSULCs and ABULCs, please see Table "A.")

While the introduction of ABULCs represents a positive development for non-residents that wish to invest or conduct business in Canada, it is critical to recognize that the legal attributes of an NSULC and an ABULC are far from identical. The subtle differences between the NSCA and the ABCA require non-residents to conduct a diligent review of both statutory regimes before deciding whether to utilize an NSULC or an ABULC under a particular set of circumstances.

Exploiting the Benefits of the ULC. As described above, the "hybrid" character of a Canadian ULC may frequently allow a non-resident investor to simultaneously reap the tax advantages afforded by both the Canadian and U.S. tax systems when structuring their cross-border affairs. Of particular interest to non-resident investors, acquisition structures utilizing Canadian ULCs have been developed to facilitate the purchase of Canadian businesses on a tax-advantaged basis for U.S. purposes without triggering significant Canadian income tax liabilities. Similarly, inbound financing structures that make use of Canadian ULCs (in some cases, in tandem with certain hybrid debt/equity instruments) have been developed in an effort to reduce the withholding tax imposed on cross-border interest payments and to facilitate the concurrent deduction of interest payments in multiple jurisdictions.

Cross-Border Acquisitions. The use of ULCs has proven to be a popular means for non-residents of Canada to acquire and hold Canadian assets or businesses. Since ULCs are regarded as corporations for Canadian tax purposes, interest, dividends, rent, and service fees paid to a ULC from a Canadian payor are not generally subject to non-resident withholding tax under Part XIII of the Income Tax Act (Canada) (the "Tax Act") or source withholdings under the regulations to the Tax Act, even though the ULC may be treated as pass-through entity for U.S. federal income tax purposes. Accordingly, U.S.-resident investors that wish to lend funds, acquire rental property, or provide services in Canada often undertake such activities through a ULC to avoid having Canadian tax withheld from Canadian-sourced receivables. In effect, the use of a ULC as an intermediary entity allows a non-resident party to internally manage its Canadian withholding tax liabilities and potentially employ strategies to reduce its aggregate Canadian withholding tax burden.

A U.S.-resident that wishes to acquire a Canadian business may also be able to secure certain U.S. tax benefits by structuring the contemplated acquisition through a ULC. In many cases, conflicts arise where a U.S.-resident wishes to purchase the assets of a particular Canadian business, while the shareholders of the Canadian business are more inclined to sell the shares of the entity that operates the business. By utilizing a ULC to effect the acquisition of the business in question, the ostensibly conflicting interests of both the Canadian vendor and the U.S. purchaser may be simultaneously satisfied.

As stated, a ULC may be viewed as a corporation for Canadian tax purposes and a disregarded entity for U.S. federal income tax purposes (*i.e.*, provided that it is wholly-owned). Thus, if the vendor shareholder were to convert the current Canadian operating entity into a ULC and then sell the shares of the converted entity to the purchaser (or more typically, a new ULC formed by the purchaser),[10] the vendor would be considered to have sold shares for Canadian tax purposes, while the U.S. purchaser would be considered to have directly acquired the assets of the underlying business for U.S. federal income tax purposes.[11] The net result of the transaction will generally be that the vendor will be entitled to favorable capital gains treatment on the sale (and avoid the indirect recapture of depreciation that might arise on a sale of assets for Canadian tax purposes), while the purchaser will obtain a "step-up" in the cost base of the assets of the target business for U.S. federal income tax purposes.

Cross-Border Financing Structures. The differing treatment of ULCs under the U.S. and Canadian tax systems often plays a pivotal role in the facilitation of tax-advantaged financing of Canadian investments held by U.S.-resident taxpayers. While there are a variety of structures that have gained acceptance, the key element of each is the potential availability of interest expense deductions on both sides of the border, or, in the case of cross-border, intra-group indebtedness, an interest expense deduction in Canada with no corresponding income inclusion for U.S. tax purposes. Planning in this area requires, among other things, a thorough understanding of the applicable withholding tax regimes in both countries, as well as the "thin-capitalization" rules under the Tax Act.

The optimal structure in a particular set of circumstances will depend, in part, upon the source of the borrowed funds (*e.g.* third-party lenders (resident/non-resident) or internal funds of the U.S. resident taxpayer). In the simplest of cases, a U.S. corporation with a wholly-owned subsidiary ULC that operates a Canadian business, or which is planning to effect a business acquisition in Canada, could arrange for the ULC to borrow the necessary funds from a third-party lender. In these circumstances, the ULC would be viewed as the borrower for Canadian tax purposes and, thus, should generally be entitled to receive a deduction (in computing its Canadian taxable income) for the associated interest expense.[12] On the other hand, the U.S. corporate shareholder would be viewed as the borrower for U.S. federal income tax purposes (in light of the ULC's disregarded status under the U.S. "Check-the-Box" regulations) and also entitled to a deduction in respect of the associated interest (thereby potentially reducing its U.S. tax liability).[13] Such an arrangement should be carefully scrutinized from a U.S. and Canadian withholding tax perspective in order to minimize the application of such taxes to interest payments made on the borrowing; possible planning techniques in this regard include, in the case of loans received from non-Canadian residents, structuring the subject loan so that it qualifies for the "long-term debt exemption" available under section 212(1)(b)(vii) of the Tax Act or having the loan made out of the Canadian branch (in the case of a Schedule III bank for purposes of the Bank Act (Canada)) of the non-resident leader.

Similar, although potentially less attractive, results may be available where, for commercial or other reasons, it is not feasible to effect the third-party borrowing at the ULC level and the borrowing is instead undertaken by the U.S. corporation, followed by an on-loan of the borrowed funds to the ULC. To ensure deductibility of the associated interest expense to the ULC for Canadian tax purposes, the arrangement must comply with the thin-capitalization rules under the Tax Act.[14] These rules operate to preclude an interest deduction by a Canadian corporate borrower in respect of its indebtedness to "specified non-residents", where such indebtedness exceeds two times the amount of the Canadian corporate borrower's "equity" (as defined in the Tax Act).[15]

While interest payments by the ULC borrower would generally be subject to Canadian withholding tax at the U.S. Treaty rate of 10%, there should be no income inclusion to the U.S. corporation in respect of the interest receipt for U.S. tax purposes (since the on-loan and the associated interest payments would be treated as disregarded inter-branch transactions or "tax nothings"). Thus, in the aggregate, a borrowing by a U.S. corporation followed by an advance of the funds to its subsidiary ULC (within the parameters permitted under the Tax Act (*i.e.*, with regard to the thin-capitalization rules)), would yield interest deductions in the United States[16] and Canada, no income inclusion in the United States in respect of interest paid by the ULC, and Canadian withholding tax equal to 10% of the interest payments made by the ULC to its U.S. parent corporation.

In circumstances where a third-party borrowing is required to finance the operations of a Canadian subsidiary of a U.S. corporation that is not a ULC (and conversion is not a feasible option, either for commercial or U.S. tax reasons[17]), a ULC may be interposed between the entities to effect the borrowing, followed by a "loan" of the borrowed funds by the ULC to the Canadian subsidiary. Rather than paying cash interest, the "loan" between the ULC and the Canadian subsidiary could allow the Canadian subsidiary to satisfy its interest obligations through the issuance of shares to the ULC. Properly structured, the ULC's receipt of such stock-settled interest payments could be treated as non-taxable stock dividends for U.S. tax purposes (in essence, by exploiting: (i) the ULC's hybrid corporate / pass-through nature; and (ii) the contrasting approaches to debt-equity characterization in Canada and the United States through the use of a hybrid debt-equity instrument[18]), while an interest expense deduction should nevertheless be available to the Canadian subsidiary for Canadian tax purposes. The ULC, for Canadian tax purposes, would have an income inclusion in respect

of the stock-settled interest received from the Canadian subsidiary and a substantially offsetting interest expense in respect of the interest payments made to the third-party lender.[19]

CONCLUSION

Entering the Canadian market presents U.S. investors with a host of business risks and rewards and the associated U.S. and Canadian tax rules provide similar challenges and opportunities. Before charging headlong into the Canadian commercial realm, U.S. taxpayers and their advisors would be wise to pause to assess the structural options available in Canada and design a strategy that is consistent with the business model of the enterprise and is tax-efficient from a cross-border perspective. From that basis, a U.S. investor will be well positioned to determine whether a ULC would add a unique dimension to the proposed structure and if so, whether the incumbent Nova Scotia ULC or its new rival from Alberta would be the most appropriate selection.

Michael W. Domanski is a partner at Honigman Miller Schwartz and Cohn LLP, where he specializes in advising clients on international tax matters and captive insurance arrangements. Mr. Domanski received a B.A. from the University of Toronto, his J.D. from Michigan State University College of Law, and his LL.M from New York University School of Law. In addition, he was recently elected to the Tax Council of the State Bar of Michigan. Todd A. Miller and Wayne D. Gray are partners at McMillan Binch Mendelsohn, LLP in Toronto, Canada where they work on cross border financing transactions and other corporate matters. Michael F. Friedman is an associate in McMillan Binch Mendelsohn's tax group.

TABLE "A"

NSULCs AND ABULCs: UNDER THE MICROSCOPE

	NSULC	ABULC
Corporate Statute	*Companies Act*, R.S.N.S. 1989, c. 81 (the "NSCA")	*Business Corporations Act*, R.S.A. 2000, c. B-9 (the "ABCA")
General Observations on Corporate Statute	The NSCA is a highly idiosyncratic statute, generally unfamiliar to U.S. investors and their U.S.-based advisors.	The ABCA is a *Canada Business Corporations Act*-like corporate statute and, therefore, an analogue of the *Model Business Corporation Act* and other U.S. statutes that formed the basis of the CBCA.
U.S. Federal Income Tax Treatment	NSULCs are expressly referred to in the Check-the-Box regulations.	The Check-the-Box regulations contemplate other Canadian ULCs qualifying as a pass-through entity for U.S. federal income tax purposes. Specifically, these rules apply to a Canadian "company or corporation all of whose owners have unlimited liability pursuant to federal or provincial law" (the "Expanded Definition"). Thus, the U.S. federal income tax treatment accorded to an ABULC turns on whether an ABULC falls within the Expanded Definition. While there is no reason to believe that an ABULC will not be treated in the same manner as an NSULC for U.S. federal income tax purposes (provided that it meets the Expanded Definition), little guidance focusing on ABULCs currently exists. Thus, taxpayers may favour NSULCs if the certainty of the U.S. federal income tax treatment is the highest priority.
Canadian Tax Treatment	An NSULC is a "Canadian corporation" under the *Income Tax Act* (Canada).	Identical to an NSULC.

	NSULC	ABULC
Incorporation Expense	If formed on incorporation or amalgamation, incorporation tax = CAN$6,000. Not applicable if formed by way of statutory arrangement.	CAN$100
Annual Filing Fee	CAN$2,000 for filing an annual statement under the NSCA.	The ABCA requires the filing of an annual return, but there is no filing fee.
Board Residency Requirements	The NSCA imposes no Canadian residency requirements on the board or on any committee of the board. Shareholders are able to elect inside or outside directors regardless of statutory residency considerations.	The ABCA requires that not less than 25% of the members of the board of an ABCA corporation (including an ABULC) be resident Canadians. Likewise, not less than 25% of the members of any board committee must be resident Canadians. The effect of the applicable Canadian residency requirements can be partly mitigated by entering into a unanimous shareholder agreement that transfers all board powers and liabilities to its shareholders (who are already exposed to unlimited liability).
Shareholder Liability Regime	Shareholders are liable for the debts and liabilities of an NSULC only upon the winding-up, dissolution or bankruptcy of the company. Shareholder liability is limited to the debts and liabilities of the NSULC and the costs of the winding up. Shareholders might not be liable for torts committed by the NSULC or contractual damages awarded against the NSULC. Finally, shareholders are not liable for the debts and liabilities of an NSULC if: (a) they ceased to be shareholders of the NSULC at least one year before the commencement of the winding-up of the company; (b) the debts or liabilities at issue arose after the shareholders ceased to hold shares of the NSULC or a court is satisfied that the existing shareholders of the NSULC are capable of covering any financial shortfall; or (c) a contract between the NSULC and the creditor limits the liability of the shareholders to contribute on a winding-up.	Shareholders are directly liable to creditors or other third parties for any liability, act or default of the ABULC. Shareholder liability is unlimited in extent and joint and several in nature and does not arise solely on liquidation of the ABULC. Most significantly, shareholders appear to be liable not only for antecedent debts (as under the NSCA), acts and defaults but also for debts, acts and defaults even after the shareholder ceases to hold shares in the ABULC. Except by virtue of generally applicable limitations laws, the ABCA contains no provision to cut-off the liability exposure of an ABULC shareholder and no provision allowing shareholders of an ABULC to contract-out of their statutory liability. Nevertheless, so long as a U.S. special purpose entity is used to hold the shares of an ABULC, the additional liability exposure of an ABULC will be largely mitigated. However, if an individual or an entity having value holds the shares of an ABULC, such shareholders could inadvertently be exposed to liability in excess of that faced by shareholders of an NSULC.
Director Liability Regime	There are no provisions in the NSCA which expressly deal with director liability. Accordingly such liability is governed by common law.	The ABCA provides that directors who authorize certain corporate activities such as the payment of dividends or the redemption of shares contrary to the applicable solvency test can be held personally liable for such activities.

	NSULC	ABULC
"Conversion" (*i.e.* the process of changing a non-ULC into ULC) or "Continuance" (a "reincorporation" in U.S. corporate law parlance).	For "conversion" into an NSULC, a corporation must first be, or continue as, a company limited by shares under the NSCA. Conversion is then effected by statutory amalgamation or arrangement (both of which require court orders). Significantly, an amalgamation automatically triggers an additional tax year-end for income tax purposes (unless it is timed to coincide with the company's ordinary tax year-end). Thus, amalgamation could trigger the acceleration or expiration of non-capital loss carry forwards. An arrangement also requires a court order but does not trigger an automatic year-end unless it includes an amalgamation. Also, there would be a temporary loss of ULC status if an ABULC is converted into an NSULC. In a recently-released discussion paper, (the "NSCA Discussion Papers"), Service Nova Scotia and Municipal Relations proposes to allow for interconversion of NSULCs and companies limited by shares without court orders and without using an amalgamation.	Limited corporations and ABULCs are inter-convertible by articles of amendment, amalgamation or arrangement under the ABCA. NSULCs or non-ULCs may be converted into ABULCs concurrently upon continuance from another jurisdiction. Only a statutory amalgamation triggers an additional year-end for tax purposes unless timed to coincide with the corporation's ordinary year-end. Only a statutory arrangement requires a court order.
Special Resolutions	In the absence of unanimous approval, a special resolution under the NSCA requires approval at two separate shareholder meetings held not less than 14 days apart – a potentially time-consuming and cumbersome process if the NSULC has numerous shareholders. However, in practice, NSULCs rarely have more than a few shareholders. In the NSCA Discussion Paper, the two-meeting requirement is proposed to be abolished.	A special resolution of an ABULC requires written unanimous consent of shareholders or the approval of not less than 2/3rds of the votes cast at a special meeting of shareholders.
Reduction in Paid-Up Capital	A court order is required under the NSCA to reduce paid-up capital (except upon a redemption of preferred shares). In the NSCA Discussion Paper, reductions in paid-up capital are proposed to be permitted without a court order subject to satisfaction of certain solvency tests.	Under the ABCA, shareholders of an ABULC can, by special resolution, reduce stated capital provided that the solvency (cash-flow and net asset) tests are met.
Share Purchase Financial Assistance	The NSCA prohibits loan, guarantee or other financial assistance given to facilitate the purchase of shares in an NSULC unless solvency (cash-flow and net asset) tests are met. The NSCA Discussion Paper proposes to explicitly permit share purchase financial assistance and abolish the solvency tests.	Exception for certain upstream and downstream financial assistance. Post-transaction notice to shareholders required in respect of all other assistance.

ENDNOTES

1. "U.S. tax" means U.S. federal income tax.
2. Subject to certain limitations, a U.S. foreign tax credit is generally available though for foreign withholding taxes applied to payments (*e.g.*, interest, dividends) made to the U.S. taxpayer. Additional relief may also be available for similar taxpayers as a result of the current reduced 15% U.S. tax rate on dividends paid by certain foreign corporations to U.S. individuals.
3. It is also possible, however, to exploit the many exceptions to and exemptions from Subpart F, and avoid the qualification of the foreign company as a "controlled foreign corporation" or a "passive foreign investment company" through the composition of the shareholders, the assets and/or income of the company.
4. *Infra* note 13.
5. The OFL rules under I.R.C. § 904 generally operate to recharacterize certain amounts of foreign source income as domestic source income to the extent that prior foreign losses had offset domestic source income. The net result is the disallowance of foreign tax credits associated with the foreign income that had been recharacterized as domestic income.
6. Corporate legislation in the Province of Nova Scotia was originally based on historical U.K. corporate legislation.
7. An NSULC is generally treated as a Canadian resident eligible for benefits under the Canada-United States Income Tax Convention (1980), as amended (the "U.S. Treaty").
8. *Supra* note 2.
9. Unlike typical Canadian corporations where liability is limited, a shareholder of a NSULC or ABULC may be responsible for the debts and obligations of the company. The impact of this liability exposure can be significantly mitigated/eliminated by interposing a U.S. shell corporation (either a "C-corporation" or an "S-corporation" for U.S. tax purposes, depending on the investor). U.S. limited liability companies (LLCs) are rarely used for this purpose in light of the Canadian revenue authority's position that LLCs are not eligible for benefits under the U.S. Treaty (unless the LLC elects to be taxed as a corporation). In circumstances where an LLC is making a Canadian investment and flow-through or disregarded treatment is desired, the interposition of an entity resident in an appropriate third jurisdiction (having a treaty with Canada) should be considered (Barbados and Luxembourg entities are often used for this purpose).
10. The use of a Canadian incorporated acquisition company (ULC or otherwise) is advantageous for several reasons. First, it ensures that the cost of the acquisition can be repatriated without Canadian withholding tax and may, in certain circumstances, allow for a step-up in the tax basis of certain assets of the target company following the wind-up/amalgamation of the target company into/with the acquisition company.
11. The Tax Act will generally allow a vendor to effect the conversion of a corporation into a ULC on a tax-deferred basis. Both the NSCA and the ABCA contain a variety of mechanisms that allow a corporation that is incorporated federally or under the laws of another province to be converted into a ULC. However, as noted in Table "A", the ABCA is far more flexible in facilitating such conversions.
12. In the share acquisition financing context, it is common for the ULC borrower to amalgamate with the target corporation following the acquisition so as to "marry" the operating income of the target corporation with the interest expense of the ULC borrower (unlike the United States, Canada does not have a consolidated tax reporting system).
13. The U.S. dual consolidated loss rules under I.R.C. § 1503(d) could limit the deductibility of the interest expense in the U.S. if the ULC generates a loss and either (i) the loss could be used to offset the income of another Canadian person, or (ii) the U.S. taxpayer fails to satisfy certain U.S. federal income tax filing requirements for the tax year in which the loss was incurred.
14. Subsection 18(4) of the Tax Act.
15. The "equity" of the ULC borrower for this purpose would comprise: (a) the "paid-up capital" and "contributed surplus" of the ULC attributable to "specified non-residents;" and (b) its retained earnings.
16. However, application of the U.S. dual consolidated loss should be carefully monitored.
17. For U.S. federal income tax purposes, the conversion from a Canadian non-ULC to a ULC would generally, absent a U.S. "Check-the-Box" filing that elects corporate treatment for the ULC, result in a liquidation that could have negative U.S. tax implications for the U.S. shareholder.
18. It is relatively common in the U.S.-Canada tax planning context to structure a "loan" such that it qualifies as equity for U.S. federal income tax purposes (pursuant to a "facts and circumstances" / substance over form approach to debt-equity characterization) and debt for Canadian tax purposes (where a "legal substance" approach generally prevails).
19. Similar to the simple structure described above, careful analysis of the withholding tax consequences will be required. In addition, it is advisable to ensure that there is a small "spread" between the interest rate applicable to the ULC's third-party borrowing and the interest charged by the ULC to the Canadian subsidiary.