

## Progress on LLCs : Some Good News, Some Bad News

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On September 23, 2008 the US Senate approved the Fifth Protocol (the “**Protocol**”) to the *Canada-U.S. Tax Convention, 1980* (the “**Treaty**”). The Protocol, expected to enter into force before the end of 2008, will have a significant impact on cross-border transactions, especially for U.S. limited liability corporations (“LLCs”). A new provision allows U.S. residents who derive Canadian income or gains through an LLC to benefit from the Treaty. Combined with new rules modifying section 116 of the *Income Tax Act*, many of the obstacles to investment and divestment faced by LLCs in the past will decrease. Unfortunately not all of these obstacles have been removed by the Protocol, and new ones may arise for LLCs disposing of their Canadian investments.

### Historical Obstacles

LLCs that are treated as “fiscally transparent” for U.S. tax purposes have historically been denied the benefit of the Treaty by the Canada Revenue Agency (**CRA**). CRA has taken the position that while an LLC is a corporation for Canadian tax purposes, an LLC that is not “subject to tax” in the U.S. is not a “resident” of the U.S. for Treaty purposes. LLC members also are not covered by the Treaty. Until recently U.S. entities that have disposed of shares of Canadian private corporations or other “taxable Canadian property” have had to negotiate complex withholding and clearance rules under section 116 of the Act in order to sell their property. Because LLCs in particular were not subject to the benefits of the Treaty, tax was frequently paid on disposition, in addition to withholding and clearance requirements.

### **The Fifth Protocol**

The new Protocol contains a new provision to allow U.S. residents who derive Canadian income or gains through an LLC to benefit from the Treaty by extending the benefits not to the LLC, but rather to the members of the LLC that are residents of the U.S. and realize income and gains “through” the LLC. As of two months after the Protocol comes into force an LLC that is the direct U.S. parent of a Canadian corporation could obtain Treaty benefits for its U.S.-resident members.

Gains from the sale of shares of a Canadian corporation by U.S. resident members of an LLC will be exempt from Canadian tax, provided that the shares do not derive their value principally from real property situated in Canada. Furthermore, any dividends or interest paid by the Canadian corporation to the LLC will be treated as earnings by the members of the LLC, leading to reduced rates of withholding tax under the Treaty. The Canadian withholding tax rate for dividends will be either 15% or 5% (the lower rate applying where the member is deemed to indirectly hold more than 10% of the voting stock of the Canadian corporation). The withholding tax rate for interest payments is discussed below.

However, the new provisions introduced by the Protocol will likely create administrative and filing concerns. LLCs may need to obtain additional information from their members and provide such information to CRA to ensure that the benefits of the Treaty are available to members. (As yet, there are no administrative policies or proposals regarding how LLCs are to obtain Treaty benefits through their members).

An LLC will likely not be attractive to non-U.S. investors. Non-U.S. investors will not be entitled to the “look-through” treatment accorded to U.S. residents, nor will they be

entitled to the benefits of a tax treaty between Canada and the investor's country of residence.

#### *Withholding Tax on Non-Arm's Length Interest*

Recent changes to the *Income Tax Act* eliminated withholding tax on interest paid to all non-resident arm's length lenders, not only to U.S. resident lenders, retroactive to January 1, 2008. The Protocol also provides for the gradual elimination of withholding tax on interest paid to related or non-arm's length parties who are U.S. residents for Treaty purposes. Assuming that the Protocol enters into force in the calendar year 2008, the reduced rate of withholding tax will be 7% in 2008, 4%, in 2009, and after January 1, 2010 that withholding tax will be eliminated. As with the proposed changes to LLCs, this change will have a significant impact on cross-border acquisitions. More specifically, access to capital for acquisitions and operating lines will increase significantly as it will be easier to access both U.S. and international debt markets, and borrowing costs will be reduced as there will no longer be the need to gross-up a foreign lender for Canadian withholding tax.

#### **Section 116 and the Canadian Clearance rules**

One of the greatest complaints of foreign investors into Canada is the requirement to obtain advance clearance certificates under section 116 of the Act each time they dispose of "taxable Canadian property" ("TCP") - including shares of private Canadian corporations. Beginning January 1, 2009, no section 116 certificate will be required in cases where a purchaser of property is satisfied, that the vendor is resident in a jurisdiction with whom Canada has a tax treaty; and (ii) the disposition of the property by the vendor would not be subject to Canadian tax by reason of that treaty (where vendor and purchaser are related, there is an additional requirement for the purchaser to notify CRA within 30 days of the disposition). A foreign vendor will also no longer be required to file a Canadian income tax return for dispositions of TCP which satisfy these conditions.

The interaction of the new section 116 rules and the Protocol for LLCs is still unclear at this time. Purchasers will likely be very careful in making their determinations that LLCs are entitled to the benefits of the Treaty, and would demand extensive evidence of the tax residence of LLC members, if they are even willing to forgo the section 116 requirements at all. At least initially, it is widely expected that an arm's-length purchasers will be unwilling to be "satisfied" by any evidence where an LLC vendor is concerned. It is hoped that CRA guidance for purchasers in these situations will emerge soon, enabling LLCs to take full advantage of these new rules.