



## The Benefits of Using an Unlimited Liability Company

By

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*This is a general overview of the subject matter and should not be relied upon as legal advice or opinion. For specific legal advice on the information provided and related topics, please contact the author or any member of the Tax Law Group.*

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## Introduction

Unlimited Liability Companies (“ULC”) have become useful vehicles for the acquisition of a Canadian business by a U.S. investor. This paper summarizes the advantages of using a ULC, the treatment of a ULC in Canada and in the U.S. and the use of a ULC in a factual setting involving the acquisition of a Canadian business.

Until recently, only Nova Scotia offered the possibility of incorporating a ULC. However, Alberta will shortly offer the possibility as well. This paper also highlights some of the differences between the ULC legislation in Nova Scotia and the ULC legislation in Alberta.

Lawson Lundell has extensive experience in structuring transaction that utilize ULCs. We encourage the reader of this paper to contact a member of our tax group to discuss whether a ULC will benefit your Canadian operations.

## What is a ULC?<sup>2</sup>

As a result of inheriting some old English law, Nova Scotia, New Brunswick and Newfoundland all had company law that permitted the incorporation of unlimited liability companies. These entities sheltered shareholders from liability in most circumstances except upon liquidation when shareholders become liable for the debts of the company in excess of its assets. As these vehicles were rarely used the enabling laws were eventually repealed except in the province of Nova Scotia. Alberta announced in 2004 that it would introduce legislation

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<sup>1</sup> For a detailed discussion see “Inbound Investment: Using Nova Scotia Unlimited Liability Companies” by Steven Peters, delivered at the 2001 Annual CTF Conference.

<sup>2</sup> For a more complete description of the corporate attributes of an NSULC, see a paper by Barry D. Horne of McInnes Cooper in Nova Scotia which is attached to this paper.

so that it too would permit the incorporation of ULCs. That legislation was introduced in 2005 and is expected to become law later this year.

A Nova Scotia ULC (or “NSULC”) is formed under section 9 of the Nova Scotia *Companies Act*, RSNS 1989, c.81 (“NSCA”), which permits a company to be incorporated “with or without liability” and “not having any limit on the liability of its members”. An NSULC is a separate legal entity and is the proper party to a contract. Shareholders of an NSULC are immune from liability for the debts and activities of the company in the normal way, however, shareholders are liable if the creditors of the NSULC obtain a court order for the winding-up of the company or if it becomes bankrupt. Current or past shareholders are then required to contribute to the payment of the NSULC’s debts and the cost of winding-up. Shareholders who disposed of their shares more than one year before the commencement of the winding-up are not liable.

Bill 16 was introduced into the Alberta legislature on March 9, 2005 and received second reading on March 23, 2005. It will amend the Business Corporations Act of Alberta (“ABCA”) to permit the incorporation of unlimited liability corporations. Under proposed section 15.2, “the liability of each of the shareholders of a corporation incorporated under the ABCA as an unlimited liability corporation for any liability, act or default of the corporation is unlimited in extent and joint and several in nature”. Thus, the liability of a shareholder under the ABCA appears to be broader in scope than under the NSCA.

The scope of the liability serves to highlight that when a ULC is used, interposing an ordinary limited liability company or limited partnership between the shareholders and the ULC should be considered to shield the shareholders of the ULC from liability.

#### Other Differences between the Two Jurisdictions

Perhaps the most fundamental difference between the NSCA and the ABCA is that the former is based upon the historical UK Companies Act. While it has been amended, it has

not been modernized and has not added some of the concepts in common modern style U.S. incorporation statutes. The ABCA is based upon these modern statutes and is similar to the corporations statute in Ontario and federally.

The residency requirements for directors is also a significant difference. Nova Scotia has eliminated any requirements for directors to be resident in Canada. Alberta, once amended by the same bill introducing ULCs, will still have a residency requirement. One-quarter of the directors of any corporation incorporated under the ABCA including ULCs must be resident Canadians.

Another significant difference is in the area of amalgamations. The ABCA provides for both short-form and long-form vertical amalgamations. The NSCA permits only long-form amalgamations. Long-form amalgamations require shareholder approval (3/4rds in Nova Scotia) while short-form amalgamations are approved solely by the directors. In addition, to shareholder approval, an amalgamation also requires court approval in Nova Scotia.

The NSCA requires court approval to return capital to shareholders. The ABCA requires shareholder approval (2/3rds) and the corporation must meet the solvency test set out in the ABCA.

One final significant difference is in the area of financial assistance. Under the ABCA, a corporation may give financial assistance to any person for any purpose, without regard to a solvency test. Under the NSCA, companies are prohibited from providing financial assistance, whether directly or indirectly, for the purpose of, or in connection with, a purchase made or to be made of any shares in the company unless the company satisfies a solvency test or an exception is available.

## Converting a Limited Company in B.C. to a ULC

As discussed later, it is sometimes advantageous to convert a limited company in B.C. (or another province) into a ULC. Unfortunately, this is not a straightforward procedure. The B.C. company must first be continued into Nova Scotia or Alberta. If Nova Scotia is chosen, then all of its shares must be transferred to a newly formed ULC. The continued company may then be wound up into, or amalgamated with, the ULC. It is also possible to convert into an NSULC by use of a plan of arrangement. The former carries the steep cost of incorporating a NSULC while the latter is somewhat more uncertain and requires appearing before the Nova Scotia courts twice.

It appears that in Alberta none of this will be necessary as a previously limited liability corporation may become an unlimited liability corporation by filing the documents necessary to amend its constating documents. As well, and unlike in Nova Scotia, a ULC may continue in to Alberta as a ULC.

The conversion of a Canadian limited liability corporation into one with unlimited liability may be a deemed windup for US purposes resulting in the realization of accrued gains for US shareholders. As a result, the conversion to unlimited liability should not be undertaken without US tax advice.

## Canadian Tax Treatment of ULCs

Under the *Income Tax Act* (the “Act”), a ULC is treated like any other corporation. Depending upon its particular features, it could be taxable as a private corporation or public corporation, but practically speaking it will generally be a private taxable Canadian

corporation. Like other Canadian corporations, a ULC is eligible for protection under the Canada-U.S. Tax Convention. This treatment has been confirmed by the CRA<sup>3</sup>.

### U.S. Tax Treatment of a ULC

On January 1, 1997, the U.S. Treasury introduced the so called “check-the-box” regulations<sup>4</sup>. These regulations provide for two types of entities namely, “per se” corporations and “eligible entities”. Per se corporations are those that are required to be treated as corporations for U.S. tax purposes. Eligible entities are those that are not per se corporations. All corporations under Canadian federal and provincial law except ULCs are listed as per se corporations. Excluded from the list of per se corporations are corporations formed under Canadian federal or provincial law if the liability of members is unlimited. Thus, ULCs incorporated or continued in Nova Scotia or Alberta are excluded from per se corporations because shareholders have unlimited liability. As a result, for U.S. tax purposes, a ULC is classified as a branch (if there is only one shareholder) or as a partnership (if there is more than one shareholder). Note that a ULC can elect to be treated as a corporation by simply checking the appropriate box on its return. If it is classified as a partnership or branch, then the ULC is treated as a flow through entity.<sup>5</sup>

In the end result the ULC is a hybrid entity – a corporation for Canadian tax purposes and a flow-through entity for U.S. tax purposes.

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<sup>3</sup> Technical Interpretations 9408195 and 9510435.

<sup>4</sup> Regulation 301.7701-1 to 301.7701-3 of the Internal Revenue Code of 1986.

<sup>5</sup> Note that if shares in a ULC are transferred resulting in two or more shareholders, this will cause the ULC to be converted into a partnership for U.S. purposes.

## Structuring U.S. Investments in Canada

The most straightforward approach to investing in Canada is a direct investment by a U.S. resident without interposing any legal entity. If the U.S. resident has a permanent establishment in Canada it will be subject to Canadian taxation in respect of business profits attributable to such permanent establishment. If the U.S. investor is a corporation, there is also a branch tax under Part XIV of the Act. The domestic branch tax rate of 25% is reduced to 5% by the Canada-U.S. Tax Convention.

A U.S. resident who pays taxes in Canada in relation to profits attributable to a permanent establishment here will generally be able to claim a foreign tax credit to offset its U.S. tax in relation to such profit.

If the U.S. resident forms a Canadian corporation to invest here, the corporation will be taxed as such in Canada. A U.S. shareholder of a Canadian corporation is generally not taxed on the corporation's income until it is distributed to the shareholder in some fashion. However, note that the U.S. has a system that taxes f.a.p.i., or what they call sub-Part F income, of a "controlled foreign corporation".

At such time as dividends are paid to a U.S. shareholder they are subject to a 5% withholding tax in Canada.<sup>6</sup> The U.S. equivalent of f.a.p.i. is deemed to be a dividend to a U.S. shareholder and taxed in the U.S. No withholding tax is payable in Canada until the dividend is actually paid.

When a U.S. corporation receives a dividend from a Canada subsidiary, it cannot deduct the dividend and it is treated as ordinary income. It can, however, claim a foreign tax credit for taxes paid by the subsidiary subject to a number of complex restrictions.

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<sup>6</sup> Article X(2) of the Canada-U.S. Convention requires that the recipient shareholder owns at least 10% of the voting shares of the corporation to qualify for the 5% rate.

## Using a ULC to Invest in Canada

### Individual Investor

A U.S. individual should consider using an “S” corporation in the U.S. and a ULC in Canada to invest in a Canadian business. An “S” corporation in the U.S. results in the income or losses of the “S” corporation flowing through to the shareholder rather than being taxed at the entity level. The individual shareholder thus can receive flow through treatment from the ULC while at the same time being insulated from liabilities of the ULC with the “S” corporation and benefiting from the lower rate of withholding tax on dividends of 5% rather than 15%. While a limited liability company<sup>7</sup> in the U.S. may seem just as attractive as an “S” corporation, they should be avoided because the CRA does not consider a limited liability company to be a resident of the U.S. for treaty purposes. As a result, treaty benefits such as the reduced rate of withholding tax are not available to a limited liability company.

An advantage of a ULC to an individual U.S. investor is that they can claim a foreign tax credit on their individual U.S. tax return for Canadian taxes paid by the NSULC. This is not available to an individual taxpayer if a limited liability corporation is used in Canada.

The following table illustrates the advantage to a U.S. individual of using an NSULC rather than an ordinary Canadian corporation:

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<sup>7</sup> A state-registered LLC can be taxed as a partnership for federal income tax purposes but its members, like corporate shareholders, are not personally liable for the liabilities of the LLC. Under the check-the-box rules, an LLC can elect partnership treatment to avoid taxation at the entity level. Also, unlike limited partners, LLC members may participate in management without risking personal liability.



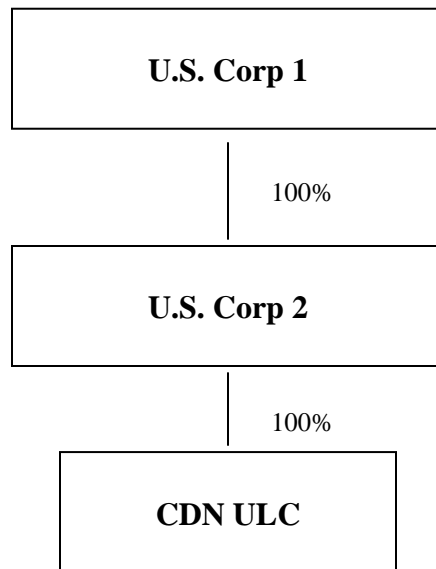
	<u>Earned in Canada</u>	
	<i>Non-ULC</i>	<i>ULC</i>
Pre-tax net income	100	100
Taxes payable by corporation	<u>(40)</u>	<u>(40)</u>
After-tax profit = dividend payable	60	60
Taxes payable by shareholder:		
Canadian dividend withholding tax @5%	(3)	(3)
U.S. federal income tax @38.6%	(23)	(39)
Foreign tax credit	<u>3</u>	<u>(39)</u>
Net federal income tax	(20)	0
State income tax @4% (no FTC)	(2)	(4)
After-tax cash	<u>35</u>	<u>53</u>
Total tax rate	<u>65%</u>	<u>47%</u>

### U.S. Corporate Investor

An important advantage to a U.S. corporation using a ULC is that any Canadian source losses can be flowed through to the U.S. corporate shareholder. Also, as with an individual investor, any Canadian corporate tax will be available as a foreign tax credit to the U.S. parent.

In addition, the U.S. corporation is able to operate as if it were a branch in Canada without being subject to the branch tax. Withholding tax will be payable when profits are paid to the U.S. by way of a dividend at the reduced treaty rate.

For example, the U.S. investor may be a “C” corporation.<sup>8</sup> The “C” Corporation may interpose a second “C” corporation between itself and the Canadian subsidiary which is the ULC.



U.S. Corp 2 serves the purpose of limiting the exposure of U.S. Corp 1 to the liabilities of ULC. The ULC is treated as a foreign branch of U.S. Corp 2 for U.S. tax purposes but no Canadian branch tax will be payable. The two U.S. corporations can elect to file a consolidated return so that the income or losses of the ULC flow through to U.S. Corp 1.

The potential foreign tax credit benefits to a “C” corporation of using a ULC are generally more modest than for an individual investor. A “C” corporation which invests in an ordinary Canadian corporation is entitled to a “deemed paid” foreign tax credit for the underlying Canadian tax paid by its subsidiary in the year in which dividends are paid. However, there are some restrictions. For example, the credit cannot be claimed if the U.S. shareholder of the

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<sup>8</sup> A “C” corporation is taxed at the entity level and any dividends are again subject to tax at the shareholder level without credit.

Canadian corporation owns between 10% and 50% of the stock. Such restrictions do not apply if the subsidiary is a ULC. A direct credit is available to the U.S. corporate shareholder for taxes paid by a ULC in the year that the Canadian taxes are paid.

### Financing Issues

If the Canadian operation is to be financed with borrowed money, typically to get the interest deduction a U.S. corporation prefers to borrow the funds and lend them to the Canadian subsidiary. If a ULC is used, it can borrow the money needed to finance its operations and for U.S. purposes, the U.S. parent is treated as the borrower and deemed to have paid the interest. This will enable the U.S. shareholder to deduct the interest expense and potentially also reduce its tax liability on U.S. source income. Borrowing at the ULC level also allows the U.S. shareholder to avoid the application of the thin capitalization rules and the interest payments by the ULC will be fully deductible in Canada.<sup>9</sup>

Another approach to financing would be for the U.S. investor to lend funds to the ULC up to the allowable limit under Canadian thin capitalization rules. Provided the interest rate approximates a market rate, the interest will be deductible by the ULC for Canadian purposes. The interest payments, however, will not be income to the U.S. investor because this will be treated as an inter-branch transaction. Accordingly, the interest will be deductible against high Canadian corporate rates subject only to the 10% withholding tax. This has been referred to as the “poor man’s double dip” because it achieves some of the benefits of a double dip without the implementation costs.

Another variation in financing is available if the Canadian subsidiary is an ordinary limited company and the U.S. parent does not want to convert it to a ULC. A ULC can be interposed between the Canadian subsidiary and the U.S. parent. The ULC then borrows

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<sup>9</sup> Some care has to be taken to plan around the possible application of U.S. withholding tax to interest payments by the NSULC to a Canadian resident lender.

from an arm's length party and lends the money to the subsidiary. The subsidiary agrees to pay interest to the ULC by issuing high paid up capital shares which are non-taxable for U.S. purposes. This achieves a deduction for the U.S. parent and for the Canadian subsidiary.

### Transfer Pricing Advantage

To minimize Canadian tax, there is an incentive to set transfer prices for goods and services between a Canadian subsidiary and its parent higher on the Canadian side. If the Canadian subsidiary were an ordinary corporation and the CRA reduced the amounts paid to the U.S. parent under the Canadian transfer pricing rules<sup>10</sup>, this would result in double taxation unless the IRS agreed to reduce the income inclusion for U.S. purposes.

If the Canadian subsidiary is a ULC, any payments by it to the U.S. parent are disregarded for U.S. purpose, therefore there is no risk of double taxation. In effect, the U.S. parent only has to be concerned with the Canadian rules on transfer pricing.

### Use of a ULC to Avoid U.S. Controlled Foreign Corporation Rules

Under the Internal Revenue Code, a controlled foreign corporation ("CFC") may be problematic for a U.S. citizen investing in Canada. The passive income of a CFC such as dividends, interests, rent and royalties must be included in the shareholder's income. To the extent of the accumulated earnings and profits of the CFC, a gain on the sale of the stock of a CFC is treated as a dividend. If a ULC is used while the income is treated as though it was earned directly by the individual shareholder (i.e. no change), the sale of the stock in the ULC is treated in the U.S. as a sale of the underlying assets which would likely qualify for capital gain treatment. The rate difference for an individual shareholder in the U.S. is about 20% because dividends are taxed as ordinary income.

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<sup>10</sup> ss. 247(2)

## Acquisition of a Canadian Corporation by a U.S. Corporation

This is perhaps the most important use of a ULC and should be considered whenever you have a case where a U.S. corporation is contemplating the acquisition of a Canadian corporation.

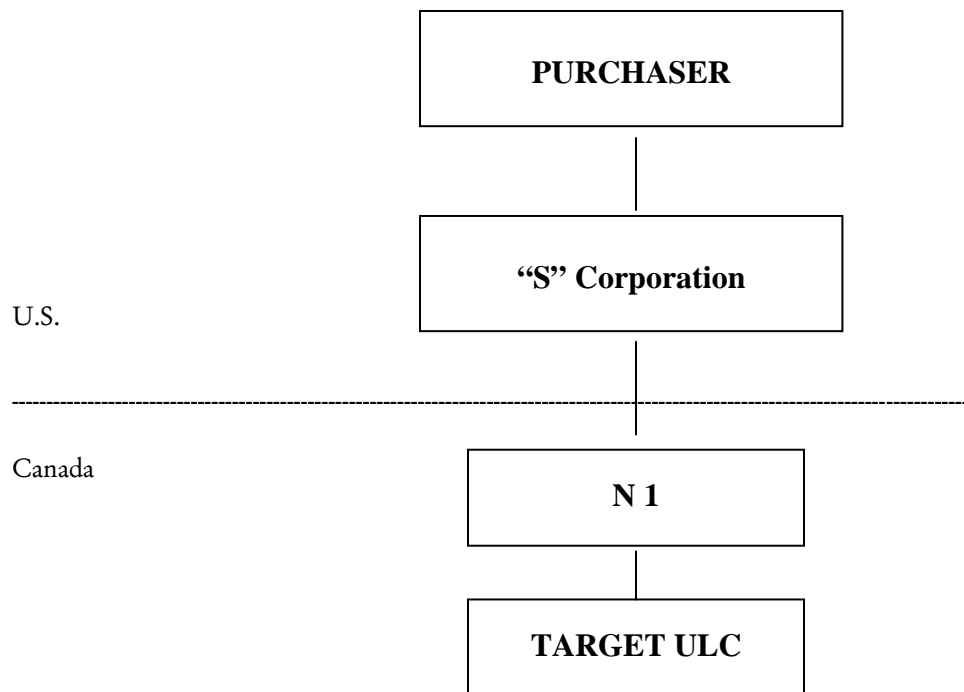
An example of a recent acquisition in which we were involved will serve to illustrate this use of a ULC.

The Canadian target corporation (“Target”) owned an operating business in B.C. For a couple of reasons the individual shareholders of the Target wanted to sell shares. Firstly, to obtain capital gain treatment but more importantly the Target was a lessee of property that was essential to its business. If the assets were sold the assignment of the lease would trigger a consent clause which was not the case if control of the corporation changed. The U.S. corporate purchaser (“Purchaser”) wanted to acquire the assets of the Target to get a stepped up basis in the assets. The use of a ULC met the objectives of both parties.

The Purchaser (a U.S. “C” corporation) first formed a subsidiary in the U.S. as a subchapter “S” Corporation. The “S” Corporation provided a layer of liability protection and preserved the desired flow through treatment for the Purchaser.

Two ULC’s (N1 and N2) were then formed in Nova Scotia. The Target was then continued into Nova Scotia and amalgamated with N2 to form Target NSULC. N1 was then capitalized by the purchaser using a combination of debt and share capital so as to stay within the thin capital restrictions on interest deductibility. N1 then proceeded to acquire the issued shares of Target ULC.

The resulting structure looks like this:



### Tax Aspects of Structure

#### Canadian Tax Treatment

The continuation of the Target into Nova Scotia and its subsequent amalgamation with N2 is not a taxable event. Target ULC inherits the cost base of the assets owned by the Target. Target ULC could be wound up into N1 and a bump under 88(1)(d) could be utilized in respect of non-depreciable property.

By establishing N1 to acquire the shares of Target ULC, the Purchaser is able to step-up the paid-up capital of the target corporation for Canadian tax purposes because the purchase price will be reflected in the paid-up capital of N1.

Target ULC will be a taxable Canadian Corporation carrying on business in B.C. through a permanent establishment here and will be taxable as such at the applicable corporate rates with no small business deduction.

## U.S. Tax Treatment

Under the “check the box” regulations the two ULC’s are disregarded for tax purposes so that the purchase of shares of the Target ULC is treated as a purchase of the assets of the Target ULC by the Purchaser under U.S. tax law. As a result the Purchaser is treated the same way for U.S. purposes as if they had purchased the assets of the Target. The Purchaser gets a step-up in basis for the assets which it is considered to have acquired. The Purchaser is thereby able to claim depreciation on the assets at their new stepped-up basis and the cost base will be recognized upon a subsequent disposition.

Under U.S. law the wholly-owned Canadian companies are tax “nothings” such that the U.S. parent is treated as owning the assets in Canada and carrying on business in Canada through a branch operation.

For U.S. purposes all income, losses and foreign tax credits generated by the underlying business in Canada are considered to be the Purchaser’s income, losses and foreign tax credits.

## Repatriation of Funds by the ULC

By capitalizing N1 with debt and preferred shares, the after-tax profits of the Target ULC can be repatriated to the U.S. parent by the redemption of preferred shares or the repayment of debt without incurring withholding tax in Canada. After the tax free repatriation of capital is complete, dividends may be paid to the “S” corporation subject to the 5% withholding tax.<sup>11</sup>

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<sup>11</sup> Note that the CCRA has confirmed that an "S" Corporation is qualified for the reduced rates under the Canada-U.S. Tax Convention, see Tax Window Files, Doc. No. 9416455

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