



Operating in Canada?

Get Ready for Tax Changes



If you're a U.S. resident with cross-border investments, better study up on some newly enacted changes to the Canada-United States Income Tax Convention (the Treaty). Under modifications to the Fifth Protocol of the Treaty, it may make sense to restructure those investments.

QUICK TAKE

- New regulations favor LLCs and S corporations
- ULCs may pay steeper taxes
- Changes take effect in January

Changes to the Treaty impact taxation of income, profits, or gains that are earned through—or paid to—unlimited liability companies (ULCs) or other fiscally transparent entities under either Canadian or U.S. law, but treated as corporations in the other country. Common fiscally transparent entities for U.S. tax purposes include limited liability companies (LLCs) and Subchapter “S” corporations.

Prior to the changes, Canada Revenue Agency took the position that LLCs and S corporations were not “residents of a contracting state,” and thus did not qualify for Treaty benefits—lower rates for withholding taxes, branch taxes, dividends, and capital gains.

Starting January 1, 2010, taxation authorities will be required to look through fiscally transparent entities such as LLCs to determine eligibility for Treaty benefits at the member level. As a result, if a U.S. resident is a member of an LLC that earns Canadian-source income for U.S. tax purposes, that income will be treated as earned by the U.S. resident and, as such, would enjoy Treaty benefits. Despite this “look through,” Canada will still treat the LLC as a separate taxpayer.



That's the good news. But there's a flip side to the Treaty changes.

While benefitting some fiscally transparent entities, others—such as Canadian ULCs—may now be denied Treaty benefits. Since ULCs are widely used by investors in Canada, this may be the time to consider making changes in the structure of cross-border investments so as to take advantage of new opportunities—and avoid possible pitfalls.

Looking to curb the use of certain hybrid financing structures, the Canadian government will deny Treaty benefits to ULCs, resulting in steeper taxes on those entities. And the difference can be significant.

Dividends paid by a ULC to a U.S. resident shareholder used to be subject to 5% withholding tax. After implementation of the new rules on January 1, 2010, that withholding rate jumps to 25%. Despite discussion about the inadvertent impact of those Treaty changes, it appears unlikely that further modifications will be made before it goes into effect in January.

In the meantime, investors might consider other options: causing the ULC to be taxed in the U.S.; using a branch operation in Canada; using instruments that are treated as debt in Canada and as equity for U.S. tax purposes; or using foreign intermediaries in a country with which Canada has a favorable tax treaty. That last option would require a careful evaluation of cost-risk benefits.

This is a complex international tax area and we recommend you look at all cross-border business investments to ensure they make the best of new tax rules. Please contact the author or Marco Dolfi, 519.790.7468, if you'd like some help.

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