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The Life and Times of Canada's ULC

The Origin...

The unlimited liability company is an archaic form of corporation tracing its origins back to the United Kingdom's *Companies Act* of 1862. In these early years of the Corporation, limited liability required more than mere incorporation. It required a Royal Charter. And so, ULCs were commonplace and have endured in the U.K. to this day.

In Canada, however, the ULC was lost to history and forgotten over the intervening one and a half centuries. Then, in the mid-1990s, a U.S. tax practitioner discovered a surviving ULC in the Canadian province of Nova Scotia. Having all the criteria of a corporation except one—limited liability, this last of the Canadian ULCs had important and hitherto unforeseen uses for U.S. tax practitioners.

Since 1997, U.S. taxpayers can choose not to recognize a Nova Scotia ULC as a corporation for U.S. tax purposes. A ULC can be ignored or, in tax parlance, treated as a "disregarded" entity. Thus, while a ULC is a corporation like any other for Canadian tax purposes, U.S. shareholders can deduct a ULC's losses against their own income, just as they would the losses of a partnership or sole proprietorship. Additional uses include the step-up in the cost base of capital assets when the ULC is used as an acquisition vehicle, an increase of foreign tax credits and more besides than can be usefully described here. So popular did Nova Scotia's ULC become, and so lucrative for that province's government, that the provinces of Alberta and British Columbia amended their corporate statutes to reintroduce the ULC in their jurisdictions as well.

The Death...

Then, after just ten years, the situation changed. In 2007, the Fifth Protocol amended the *Canada-U.S. Tax Convention (1980)* to deny treaty benefits to U.S. recipients of income, profits or gains paid by ULCs. What this means is that payments of dividends, rents, royalties, interest and similar passive forms of income remain subject to the full 25% tax rate under Canada's *Income Tax Act*, without the usual treaty reductions and exemptions. Effective as of January 1, 2010, this change sounded the death knell of the ULC. But, is the ULC truly dead?

And the Resurrection

The Canada Revenue Agency has endorsed a seemingly superficial solution to the Fifth Protocol. According to its plain wording, the treaty amendment applies only to amounts that would be treated differently for U.S. and Canadian tax purposes by reason of the ULC being "fiscally transparent" (a disregarded entity) under U.S. law. Consequently, this limitation can be avoided, first, by increasing stated capital by the amount that would otherwise be distributed as a dividend and then distributing the amount of this increase as a non-taxable return of capital.

The addition to stated capital results in a taxable dividend for Canadian tax purposes. Since this is a non-taxable event in the U.S. regardless of whether the ULC is fiscally transparent, it cannot be said that the treatment differs in the U.S. by reason of the ULC being a disregarded entity. The treaty therefore continues to apply, reducing the applicable rate from 25% to either 5% or 15%, according to whether the dividend recipient owns more or less than 10%

of the ULC's voting shares. Next, the subsequent distribution of stated capital is a non-taxable event in both jurisdictions, regardless of the disregarded nature of the ULC. Treaty protection at this stage is therefore both available and unnecessary.

One may rightly wonder why this particular treaty amendment was made at all.

About the Author
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Patrick Westaway is Tax Counsel to Sorbara, Schumacher, McCann LLP, one of the largest and most respected regional law firms in Ontario. Patrick advises on a broad range of Canadian taxation issues such as corporate tax planning, structuring inbound investments, corporate reorganizations, cross-border financings, tax opinions for public disclosure documents, tax assessments, personal tax matters, wealth preservation, and on federal and provincial sales tax matters (HST/GST/PST). Patrick also practices corporate and commercial law with an emphasis on the implementation of matters related to his tax planning practice.

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