

PRIVATE EQUITY FUNDS ARE DISAPPOINTED WITH RECENT CHANGES TO THE US/CANADA INCOME TAX TREATY

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Good News for LLCs

Private equity funds that have limited liability companies as partners and that invest in Canada may benefit from a recently signed Protocol to the US/Canada income tax treaty. Currently, Canada does not recognize US LLCs as US residents entitled to benefits under the treaty. Once the Protocol has been ratified by the US and by Canada and becomes effective (but not before January 1, 2008), the *US members* of most US LLCs will be recognized as US residents entitled to benefits under the treaty, in much the same way that partners in partnerships are treated now.

Example: A US LLC with two US corporate members sells stock of a private Canadian company. Canada imposes a 25% withholding tax on the sale, but the tax is reduced to zero by the US/Canada treaty. Formerly, LLCs and their members did not qualify for this treaty benefit. Once the Protocol is ratified, the Canada Revenue Agency will look through the LLC to its two US corporate members, who can qualify for the zero tax rate.

... But a Major Headache Remains for Private Equity Funds

In order to qualify for the zero tax rate, a US taxpayer must file an application with the CRA. For this purpose, the CRA looks through partnerships (including most private equity funds) to their investors, and if any of them is a partnership, the CRA looks through them, and so on. For a typical private equity fund, dozens and perhaps hundreds of applications may be required, and the process can require many months to complete. Moreover, each applicant is required to file a Canadian income tax return for the year of sale. Accordingly, when investing in Canada, US private equity funds will continue to use strategies such as investing through a Luxembourg or Barbados "blocker" entity, or insisting that the Canadian company restructure itself as a subsidiary of a Delaware holding company so that the US private equity fund can invest in the Delaware holding company.

... And Private Equity Funds That Invested Through Nova Scotia or Alberta Unlimited Liability Companies Should Reassess That Structure

Many US investors have invested in Canadian operating companies through ULCs to achieve a stepped-up basis in the assets of the Canadian companies for US tax purposes. After a phase-in period continuing at least through 2009, the Protocol may deny the reduced treaty rate of withholding tax on dividends and interest paid by a ULC to a US shareholder, so that the full Canadian 25% withholding tax may apply. This could make repatriation of earnings prohibitively expensive, and private equity funds should consider structural changes now.

For More Information

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