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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	Chapter 11
Motors Liquidation Company., et al., *f/k/a General Motors Corp., et al.,*	:	Case No. 09-50026 (REG)
Debtors.	:	(Jointly Administered)

RESPONSE OF GREEN HUNT WEDLAKE, INC., TRUSTEE OF GENERAL MOTORS NOVA SCOTIA FINANCE COMPANY, TO OFFICIAL COMMITTEE OF UNSECURED CREDITORS' FIRST AMENDED OBJECTION TO CLAIMS FILED BY GREEN HUNT WEDLAKE, INC. AND NOTEHOLDERS OF GENERAL MOTORS NOVA SCOTIA FINANCE COMPANY AND MOTION FOR OTHER RELIEF

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Green Hunt Wedlake, Inc., in its capacity as trustee (the "**Nova Scotia Trustee**") for General Motors Nova Scotia Finance Company ("**GM Nova Scotia**"), by and through its undersigned counsel, hereby submits this response (the "**Response**") to the *Official Committee of Unsecured Creditors' First Amended Objection to Claims Filed by Green Hunt Wedlake, Inc. and Noteholders of General Motors Nova Scotia Finance Company and Motion for Other Relief* (Docket No. 7859) (the "**Objection**").[1] In support of this Response, the Nova Scotia Trustee respectfully represents as follows:

PRELIMINARY STATEMENT[2]

1. By its Objection, the Committee seeks to expunge, reduce and/or subordinate (i) claims asserted by the Nova Scotia Trustee on account of Old GM's statutory obligations to GM Nova Scotia, and (ii) claims asserted by certain holders of notes (the "**Noteholders**") issued by GM Nova Scotia and unconditionally guaranteed by Old GM on account of such guarantee.

2. The Committee bases its Objection primarily on the allegation that when Old GM, GM Nova Scotia and the Noteholders negotiated a prepetition lock up agreement to facilitate the sale of substantially all of Old GM's assets to New GM (the "**363 Sale**"), the Noteholders and New GM allegedly engaged in inequitable conduct to the detriment of Old GM, its estate and its creditors—despite the undisputed input and oversight of the United States and Canadian governments throughout these negotiations. Specifically, the Committee asserts that the Noteholders and New GM managed to take advantage of (i) Old GM's precarious financial position, (ii) its need to resolve prepetition litigation with the Noteholders and (iii) the conditions precedent placed on Old GM by the US and Canadian governments in connection with the 363

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[1] The Nova Scotia Trustee also joins in the *Response Of Certain Noteholders In Opposition to Official Committee of Unsecured Creditors' First Amended Objection to Claims Filed by Green Hunt Wedlake, Inc., And Noteholders of General Motors Nova Scotia Finance Company And Motion for Other Relief* (Docket No. 8084) (the "**Noteholders' Response**").

[2] Terms not otherwise defined herein shall have the meanings ascribed to such terms in the Objection.

Sale to extract hundreds of millions of dollars in consent fees and other benefits that depleted the value of Old GM's assets and provided the Noteholders with a double recovery on their notes. The Committee's protestations are belied by the facts and the law and cannot be sustained.

3. As set forth in detail below, (i) the prepetition lock-up agreement was negotiated at arm's length and in good faith among the parties thereto—with the supervision and approval of the US and Canadian governments to facilitate the 363 Sale; (ii) the obligations incurred by the parties under the lock-up agreement were incurred in exchange for fair and just consideration; and (iii) the claims asserted by the Nova Scotia Trustee and the Noteholders are wholly separate and distinct. Accordingly, the claims should be allowed and the Committee's Objection should be overruled.

BACKGROUND

A. GM Nova Scotia and the Nova Scotia Trustee

4. On October 9, 2009, the Supreme Court of Nova Scotia (i) adjudged GM Nova Scotia bankrupt under the Canadian Bankruptcy and Insolvency Act (the "**BIA**") and (ii) appointed the Nova Scotia Trustee as an officer of the court and the fiduciary charged with overseeing GM Nova Scotia's winding up proceeding, including realizing on GM Nova Scotia's assets and satisfying its liabilities. *See (Re) Bankruptcy of General Motors Nova Scotia Finance Co.* (2009), [Hfx. No. 318069] (Can. N.S. Sup. Ct.) (attached as Exhibit A); Bankruptcy and Insolvency Act, R.S.C. 2010, c. B-3, s. 77 (Can.) (any amount owed by a shareholder or member of a bankrupt corporation is an asset of the corporation and payable to the trustee). GM Nova Scotia is a Nova Scotia unlimited liability company (a "**ULC**") formed under the *Companies Act* (Nova Scotia), being Chapter 81 of the Revised Statutes of Nova Scotia, 1989, as amended (the "**Companies Act**") and is a direct, wholly-owned subsidiary of Old GM.

5. Old GM formed GM Nova Scotia as a financing vehicle for the General Motors group of companies in 2001 in order to take advantage of favorable tax laws in Canada and the United States. At the time GM Nova Scotia was created, the Nova Scotia ULC structure was widely used by US companies in tax planning for investments in Canada because, under the law at that time and without causing other adverse tax consequences, a ULC could be classified as a corporation for Canadian income tax purposes and as a branch (or a disregarded entity) for US federal income tax purposes. This corporate structure, coupled with the structuring of funds transfers from one Canadian entity to another, afforded a multi-faceted, multinational corporation like Old GM and its affiliates the opportunity to obtain significant tax savings.[3]

6. While the ULC structure provided a US parent corporation, such as Old GM, with the potential for substantial tax benefits, pursuant to Section 135 of the Companies Act, if the ULC ever became insolvent, the US parent corporation would become primarily liable for all of the ULC's unpaid liabilities. *See* Companies Act, R.S.N.S., 1989, c. 81, s. 135 (Can.). Section 135 provides:

> In the event of a company being wound up, every present and past member shall, subject to this Section, be liable to contribute to the assets of the company to an amount sufficient for payment of its

[3] For example, under a widely employed financing strategy using a Nova Scotia ULC, the ULC would borrow from an unrelated bank and then transfer the proceeds of that borrowing to a Canadian sister company as an intercompany loan for Canadian income tax purposes. The Canadian sister company would then use the funds from the ULC in its normal operations (including possibly to refinance existing debt) and it could take a tax deduction for Canadian income tax purposes on the interest it paid on the intercompany loan to the ULC. The ULC, in turn would be entitled to an interest deduction for such purposes for interest it paid to the third party lender. For US income tax purposes, the ULC is treated as a branch of the US parent company and, as a result, the parent is entitled to deduct any interest the ULC pays to the third party lender. If the "loan" from the ULC to the Canadian sister company can be structured as equity for US income tax purposes, it is possible to structure the payments from the Canadian sister company to the ULC (which are considered to be made directly to the US parent company for US income tax purposes) to be largely tax free for US income tax purposes. If this plan could be successfully implemented, the global group would effectively enjoy a double deduction for the interest incurred on the ULC's debt. In the years at issue, this type of planning in the US-Canadian context was only possible because of the characteristics of the ULC. There are also many other ways in which ULCs were used by multinational corporations to implement US-Canadian tax planning, some of which may have been applicable to GM Nova Scotia and Old GM. *See* Barry D. Horne, *The Nova Scotia Unlimited Liability Company: Surf and Turf*, *in* REPORT OF PROCEEDINGS OF THE FIFTY-SEVENTH TAX CONFERENCE CONVENED BY THE CANADIAN TAX FOUNDATION 26:1, 26:25–29 (2005) (attached hereto as Exhibit B).

> debts and liabilities and the costs, charges, and expenses of the winding up . . . .

Id.

B. The Nova Scotia Notes, the Intercompany Loan and the Swap Arrangements

7. On July 10, 2003, GM Nova Scotia issued £350,000,000 in principal amount of 8.375% Guaranteed Notes due December 7, 2015 (the "**2015 Notes**") and £250,000,000 in principal amount of 8.875% Guaranteed Notes due July 10, 2023 (the "**2023 Notes**" and, together with the 2015 Notes, the "**Nova Scotia Notes**") pursuant to that certain Fiscal and Paying Agency Agreement among GM Nova Scotia, General Motors Corp., Deutsche Bank Luxembourg S.A., as fiscal agent, and Banque Général du Luxembourg S.A., as paying agent, dated as of July 10, 2003 (the "**Fiscal and Paying Agency Agreement**"). Pursuant to the Fiscal and Paying Agency Agreement, Old GM fully and unconditionally guaranteed the repayment of the Nova Scotia Notes (the "**Guarantee**").

8. In furtherance of the ULC tax structure, the proceeds of the Nova Scotia Notes were loaned by GM Nova Scotia to General Motors of Canada Limited ("**GM Canada**") in a series of intercompany transactions resulting in intercompany obligations owing from GM Canada to GM Nova Scotia (collectively, the "**Intercompany Loan**"). GM Canada then used the proceeds of the Intercompany Loan to assist in the funding of the General Motors group's global operations.

9. At the same time GM Nova Scotia issued the Nova Scotia Notes, it entered into a series of currency swap arrangements with Old GM (the "**Swap Arrangements**"). Pursuant to an ISDA master agreement and two currency swap confirmations dated July 10, 2003 (one for each issuance of the Nova Scotia Notes), GM Nova Scotia exchanged the British pounds it received in respect of the issuance of the Nova Scotia Notes for Canadian dollars. The swap

agreement contemplated annual payments between the parties, based on the exchange rates and the rates set forth in the swap confirmations.

10. As of the date GM Nova Scotia was declared bankrupt by the Canadian Supreme Court, CDN $1,088,542,512.01 (US $1,042,735,554.56) in unpaid principal and interest (the "**Note Liability**") was outstanding on account of the Nova Scotia Notes and CDN $589,292,176.53 (US $564,493,957.00) was owed by GM Nova Scotia to New GM under the Swap Arrangements (the "**Swap Liability**").[4] In addition, GM Nova Scotia had other unpaid ordinary course liabilities, and the Nova Scotia Trustee has incurred and continues to incur costs, charges and expenses associated with GM Nova Scotia's bankruptcy (collectively with the Note Liability and the Swap Liability, the "**GM Nova Scotia Liabilities**").

C. The Two Proofs of Claim at Issue

11. In accordance with Section 135 of the Companies Act and applicable provisions of the United States Bankruptcy Code, on November 25, 2009, the Nova Scotia Trustee filed an initial proof of claim (claim no. 65814) against Old GM for not less than US $1,607,647,592.49 on account of the GM Nova Scotia Liabilities (the "**Initial Section 135 Claim**"). On November 30, 2009, the Nova Scotia Trustee filed an amended proof of claim (claim no. 66319), providing additional detail regarding the Initial Section 135 Claim (the "**Section 135 Claim**").[5]

12. Unlike other chapter 11 cases where an indenture trustee or other representative files a global proof of claim on behalf of the noteholders, in the instant case, the fiscal and paying agents have *not* filed proofs of claim. On November 30, 2009, certain of the Noteholders filed proofs of claim (claim nos. 66216, 66217, 66218, 66265, 66266, 67429, 67499, 66312,

[4] Old GM transferred all of its rights in connection with the Swap Arrangement to New GM pursuant to the 363 Sale.

[5] On November 8, 2010, the Initial Section 135 Claim was expunged from Old GM's claims register, with the Section 135 Claim remaining as the sole proof of claim filed by the Nova Scotia Trustee against Old GM.

66267, 67428, 67430, 67498 67500, 67501) against Old GM for a total of US $758,486,107.64 based on Old GM's specific contractual obligations to the Noteholders pursuant to Old GM's guarantee on the Nova Scotia Notes (the "**Guarantee Claim**"). Out of an abundance of caution, Greenberg Traurig, LLP, as counsel to certain of the Noteholders, filed an additional claim (claim no. 69551) for the full amount of the Guarantee Claim (US $1,072,557,531.72), minus the amounts asserted in the Noteholders' individual proofs of claim, for a total claim of US $314,071,424.08. Additional Noteholders have also filed proofs of claim on account of Old GM's liability under the Guarantee of the Nova Scotia Notes.

D. The Lock Up Agreement

13. Prior to the commencement of these chapter 11 cases, Old GM and its subsidiaries, including GM Nova Scotia, engaged in a number of unsuccessful attempts to restructure their debts including, among other things, a failed exchange offer in respect of the Nova Scotia Notes. *See Disclosure Statement for Debtors' Amended Joint Chapter 11 Plan* (Docket No. 8023) (the "**Amended Disclosure Statement**") 13–14. Once the out-of-court restructuring efforts failed, the only viable option for Old GM was to sell substantially all of its assets to New GM pursuant to the 363 Sale. *Id.* at 16.

14. In order for New GM to agree to the 363 Sale, however, Old GM was required to work with its creditor constituencies to create a viable and acceptable restructuring transaction within a sixty day deadline. *Id.* at 12–13. Had Old GM been unable to meet this sixty-day deadline, the US and Canadian governments would have refused to provide essential funding for Old GM's continued business operations or to facilitate the 363 Sale to New GM, and Old GM would have liquidated. *Id.* at 12–13, 29.

15. Equally critical to Old GM's restructuring was the sale of its equity interest in GM Canada to New GM. But in order to complete this sale by the US and Canadian

governments' deadline, GM Canada had to be kept out of bankruptcy, which required an immediate deleveraging of GM Canada's balance sheet, including the elimination of the Intercompany Loan owed by GM Canada to GM Nova Scotia. To compromise the Intercompany Loan and facilitate the sale of GM Canada to New GM, GM Nova Scotia signed an agreement with GM Canada, Old GM and certain of the Noteholders providing for their mutual cooperation in connection with the 363 Sale and Old GM's restructuring (the "**Lock Up Agreement**").

16. The Lock Up Agreement was the product of extensive, arm's length negotiations among Old GM, GM Canada and their significant creditor constituencies. Each of these parties was represented by experienced counsel and financial advisors. And with the oversight and approval of the US and Canadian governments, the Lock Up Agreement was signed on June 1, 2009. It contained the following material agreements:

- GM Nova Scotia, GM Canada and Old GM agreed that (i) the Section 135 Claim is enforceable against Old GM as a general unsecured claim to the fullest extent permitted by applicable laws, (ii) the Nova Scotia Notes are enforceable against GM Nova Scotia in their full amount and (iii) the Guarantee Claim is enforceable against Old GM as a general unsecured claim to the fullest extent permitted by applicable laws. *See* Lock Up Agreement ¶ 6(a), (b)(ii).

- GM Nova Scotia agreed to consent to entry of an order under the BIA and to the appointment of the Nova Scotia Trustee. *See* Lock Up Agreement ¶ 6(b)(i).[6]

- GM Canada funded the Consent Fee into an escrow account, which would be payable to the Noteholders upon their passing an extraordinary resolution (the "**Extraordinary Resolution**"). *See* Lock Up Agreement ¶ 2.

- GM Canada was relieved of its liability in respect of the Intercompany Loan; provided, however, that if the Consent Fee was ever successfully challenged, the full amount owing under the Intercompany Loan would be automatically reinstated and be deemed immediately due and payable by GM Canada to GM Nova Scotia. *See* Lock Up Agreement ¶ 5(b).

[6] Although GM Nova Scotia agreed not to contest the winding up petition, based on the Supreme Court of Nova Scotia's finding that GM Nova Scotia was insolvent, GM Nova Scotia would have been adjudged bankrupt regardless of the consent provided under the Lock Up Agreement.

- The Noteholders agreed to discontinue prosecution of certain litigation against GM Nova Scotia, GM Canada, Old GM and their respective officers and directors, provided that the action could be reinstituted if the Consent Fee was required to be disgorged. *See* Lock Up Agreement ¶ 5(a).

- Old GM agreed that if, for any reason, any portion of the Section 135 Claim was disallowed, GM Nova Scotia's liability to Old GM in respect of the Swap Liability would be subordinated to full repayment of the Nova Scotia Notes. Old GM further agreed not to assert any setoff rights with respect to the Section 135 Claim. *See* Lock Up Agreement ¶ 6(b)(v), (vi).

- GM Nova Scotia agreed to convene a meeting of the Noteholders to pass the Extraordinary Resolution to amend the Fiscal and Paying Agency Agreement to reflect the foregoing material agreements.

In connection with the 363 Sale, Old GM assumed and assigned the Lock Up Agreement to New GM.

17. Consistent with its obligation under the Lock Up Agreement, GM Nova Scotia convened a meeting of the Noteholders on June 25, 2009 to consider the Extraordinary Resolution in accordance with the procedures required by the Fiscal and Paying Agency Agreement to amend the same to reflect the compromises set forth in the Lock Up Agreement. Pursuant to the Fiscal and Paying Agency Agreement, a special quorum of the Noteholders was required to approve the Extraordinary Resolution to make the provisions of the Lock Up Agreement binding on the remaining Noteholders. As demonstrated by Exhibit D to the Section 135 Claim, this approval was obtained.

RESPONSE

A. The Claims are Not Duplicative

18. The Section 135 Claim and the Guarantee Claim are separate, distinct claims. As outlined above, the Section 135 Claim arises directly as a result of Old GM purposefully creating GM Nova Scotia as a ULC under the Companies Act. Again, structuring GM Nova Scotia as a ULC allowed Old GM the opportunity to reap substantial tax benefits, but also required it to pay

all of GM Nova Scotia's debts in the event that GM Nova Scotia commenced a winding up proceeding under the BIA. In accordance with its statutory mandate, the Nova Scotia Trustee is in the process of winding up GM Nova Scotia, and Old GM, having already received the benefits associated with structuring GM Nova Scotia as a ULC, is required to satisfy the liabilities set forth in the Section 135 Claim that it statutorily assumed through the use the ULC structure. Indeed, allowance of the Section 135 Claim is in accord with Canadian law and consistent with applicable provisions of the Bankruptcy Code. Bankruptcy and Insolvency Act, R.S.C. 2010, c. B-3, s. 77 (Can.); Companies Act, R.S.N.S., 1989, c. 81, s. 135 (Can.).

19. By contrast, the Guarantee Claim asserted by the Noteholders is a direct contract claim that the Noteholders have against Old GM pursuant to the express Guarantee contained in the Fiscal and Paying Agency Agreement. The Guarantee provides the Noteholders with an avenue of recovery on the Nova Scotia Notes in addition to their claims against GM Nova Scotia. The mere fact that Old GM is required to satisfy the Guarantee Claim and the Section 135 Claim does not render such claims duplicative. Rather, as shown by applicable legal precedent in this Circuit, so long as the Noteholders do not receive more than payment in full on account of the Nova Scotia Notes, the allowance of both the Guarantee Claim and the Section 135 Claim in the amounts asserted is appropriate. *See Northwestern Mut. Life Ins. Co. v. Delta Air Lines, Inc. (In re Delta Air Lines, Inc.),* 608 F.3d 139 (2d Cir. 2010).

20. In *Delta*, the debtor objected to the claims filed by creditors, who owned planes leased by the debtor, to recover under tax indemnity agreements ("**TIAs**"). *Id.* at 144. The TIAs were negotiated to provide the creditors reimbursement for tax benefits lost upon foreclosure of the creditors' planes in the event Delta defaulted on its lease payments. *Id.* at 143. The leases also provided that Delta pay a stipulated loss value ("**SLV**"), which similarly reimbursed the

creditors under the lease for lost tax benefits, if Delta defaulted on its lease payments. *Id.* Once Delta defaulted on the leases, the creditors filed claims in respect of the SLV and the TIAs. *Id.* at 144. Delta objected to the claims arguing that they were duplicative. *Id.* at 149. The Second Circuit, however, found that the parties intended that payment of the TIAs was mandated only if the SLV was not paid *in full*. *Id.* at 149. Acknowledging that as a result of a bankruptcy, unsecured creditors may receive less than a 100% recovery on account of their claims, the Second Circuit allowed both the TIA claim and the SLV claim, subject to an aggregate recovery to the creditors of 100%. *Id.* at 147.

21. In so holding, the Second Circuit expressly rejected the very same argument made by the Committee in its Objection (i.e., that "multiple recoveries for the same injury are disallowed in bankruptcy" Committee Objection at 21). *Id.* at 149–50. The Second Circuit held:

> As an alternative basis for affirmance, Delta argues that a single loss can only give rise to a single claim in bankruptcy . . . notwithstanding that the TIA claims and SLV claims arise under agreements (1) between different parties, (2) addressing different events, and (3) providing for different remedies. In light of these facts, we agree with the bankruptcy court that: Each agreement was freely negotiated and fully supported by fair consideration on both sides. If a component of the SLV claim under the Lease is calculated by reference to the owner participant's tax consequences which are indemnified under the TIA (the 'overlap' Delta objects to), so be it. That is what Delta agreed to and what both the owner participant and the indenture trustee relied upon in negotiating the agreements. If Delta has contracted to pay duplicative claims, then it must pay both - it cannot repudiate its duty to party A under contract A by asserting that it contracted to pay the same amount to party B under contract B.

Id. at 149.

22. Cases addressing the issue of substantive consolidation are also instructive. For example, in *In re Owens Corning,* 419 F.3d 195 (3d Cir. 2005), a number of subsidiaries of Owens Corning had provided guarantees in order to induce banks to make a loan to their parent, Owens Corning. *Id.* at 201. Owens Corning and the subsidiaries subsequently filed for chapter

11, and Owens Corning sought to substantively consolidate all of the debtor entities for plan of reorganization purposes. *Id.* at 202. As this Court is aware, substantive consolidation would have resulted in the banks having only a single claim against the consolidated Owens Corning enterprise for the amount outstanding on the loan as opposed to multiple claims on account of its debt against each of the parent company and the guarantor subsidiaries. The banks objected to the proposed consolidation, arguing that such a result would destroy the benefit they bargained for when agreeing to the loan, i.e., the right to pursue its claim against each of the subsidiary guarantors. *Id.* at 212-13. The Third Circuit agreed, holding that the Owens Corning entities should not be consolidated because it would punish the bank, overlook its bargained-for benefit, and disrupt the corporate structure that had been created by the debtors. *Id.* at 212–13, 216. The Court found, in part:

> [The banks] loaned $2 billion to [the parent] and enhanced the credit of that unsecured loan indirectly by subsidiary guarantees covering less than half the initial debt. What the [bank] got in lending lingo was "structural seniority"— a direct claim against the guarantors (and thus against their assets levied on once a judgment is obtained) that other creditors of [the parent] did not have. This kind of lending occurs every business day. To undo this bargain is a demanding task.

Id. at 212; *accord Chemical Bank New York Trust Co. v. Kheel,* 369 F.2d 845, 848 (2d Cir. 1966) ("Equality among creditors who have lawfully bargained for different treatment is not equity but its opposite.").

23. What *Delta* and *Owens Corning* have in common is a recognition that debtors in bankruptcy must live with the contracts and corporate structures they established pre-bankruptcy. This case should be no different. Here, Old GM elected to use the tax-saving ULC structure to help fund its operations. The Noteholders then lent money to the ULC—GM Nova Scotia—and negotiated for and received a guarantee from Old GM. Just as in *Delta* and *Owens Corning*, Old GM is bound by the corporate structure it elected to utilize *and* the Guarantee it agreed to issue

in connection with the notes offering. To hold otherwise would have the inequitable result of permitting Old GM the opportunity to reap the substantial tax benefits associated with the ULC structure while avoiding the risks attendant thereto and, at the same time, denying the Noteholders the benefit of their bargain regarding the Guarantee.

B. The Committee's Other Objections are Without Merit

24. In addition to its unpersuasive argument that the Section 135 Claim and the Guarantee claim are duplicative, the Committee also seeks disallowance or subordination of both claims under the following, equally meritless theories: (i) that Bankruptcy Code section 502(d) mandates disallowance of the claims because the payment of the Consent Fee is avoidable as a preference or fraudulent conveyance; (ii) that both claims should be equitably subordinated because the Noteholders took undue advantage of their bargaining power in connection with the Lock Up Agreement; (iii) that the Lock Up Agreement constituted an unauthorized Bankruptcy Rule 9019 settlement and must be unwound; and (iv) that the Consent Fee should be deemed a principal paydown on the Nova Scotia Notes. Each of these theories is addressed below.

1. Bankruptcy Code Section 502(d) is Inapplicable

25. The Committee asserts in its Objection that the Section 135 Claim and the Guarantee Claim should be disallowed under Bankruptcy Code section 502(d) because Old GM's loan to GM Canada that was subsequently transferred to GM Nova Scotia in settlement of independent obligations and used for payment of the Consent Fee was avoidable as a preference or fraudulent conveyance. This argument is factually and legally flawed.

26. First, as discussed in detail in the Noteholders' Response, in order for the Committee to rely on Bankruptcy Code section 502(d), the Committee must have obtained a finding by the Court that the Consent Fee was an avoidable transfer and that the Noteholders or

GM Nova Scotia are liable for the turnover of such amounts under the Bankruptcy Code. As no such judgment exists, Bankruptcy Code section 502(d) is inapplicable.

27. Second, to the extent Old GM had a viable cause of action under chapter 5 of the Bankruptcy Code to avoid the loan by Old GM to GM Canada or the payment of the Consent Fee—which it does not—all avoidance actions related to the loan were transferred by Old GM to New GM in connection with the 363 Sale and, thus, Old GM's estate does not own such cause of action or have an entitlement to any proceeds therefrom.

28. Third, the funds received by GM Nova Scotia to pay the Consent Fee did not constitute property of the Old GM's estate because GM Nova Scotia received the funds from GM Canada in exchange for significant value, including the release of intercompany loans in excess of $1 billion. As neither GM Nova Scotia nor the Noteholders are in possession of property of Old GM's estate that could be returned, the Committee's 502(d) argument fails. *See Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.),* 379 B.R. 425, 443 (S.D.N.Y. 2007) (noting that the purpose of section 502(d) is to compel a recipient of an avoidable transfer to return proceeds to the estate and holding "[t]hat purpose would not be served if a claim in the hands of a claimant could be disallowed even where that claimant never received the preference to begin with, and as a result, could not be coerced to return it").

29. Fourth, the Committee's attempt to argue that Old GM's entry into the Lock Up Agreement itself is avoidable and would prevent a recovery under the Section 135 Claim is unsupportable. As discussed in detail above, the Section 135 Claim is an independent statutory claim against Old GM as the parent of GM Nova Scotia. The Section 135 Claim does not arise under, nor is it dependent upon, the Lock Up Agreement. Moreover, in the unlikely event this Court finds that there were obligations incurred under the Lock Up Agreement that are avoidable

as to GM Nova Scotia, Bankruptcy Code section 502(d) remains inapplicable to the Section 135 Claim. Bankruptcy Code section 502(d) does not require disallowance of a claim on the basis that a creditor was the recipient of an avoidable *obligation* incurred by the debtor; the avoidance of the obligation is sufficient relief. *See In re Asia Global Crossing, Ltd.,* 333 B.R. 199, 202 (S.D.N.Y. 2005) (holding that 502(d) applies to avoidable transfers but not to avoidable obligations). Thus, avoidance of the Lock Up Agreement would in no way absolve Old GM of liability on the Section 135 Claim, which exists under Canadian law.

2. There are No Grounds to Equitably Subordinate the Section 135 Claim

30. In the Committee's one-paragraph request for equitable subordination, which notably lacks any reference to governing case law, the Committee does not allege inequitable conduct by the Nova Scotia Trustee. Rather, the Committee merely argues that the conduct of the Noteholders and New GM "can and should be imputed" to the Nova Scotia Trustee. This argument does not withstand scrutiny.

31. A majority of courts have adopted a three-part test to determine whether a claim should be equitably subordinated, which test was first articulated in *In re Mobile Steel Co*. (the "***Mobile Steel* Test**"): (i) the claimant must have engaged in some type of inequitable conduct; (ii) the misconduct must have resulted in injury to the creditors or conferred an unfair advantage on the claimant; <u>and</u> (iii) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code. *See Benjamin v. Diamond (In re Mobile Steel Co.),* 563 F.2d 692, 699–700 (5th Cir. 1977); *accord U.S. v. Noland*, 517 U.S. 535, 538–39, 116 S. Ct. 1524, 1526 (1996); *but cf. Official Comm. of Unsecured Creditors of Verestar, Inc. v. American Tower Corp*. (*In re Verestar, Inc*.), 343 B.R. 444, 461 (Bankr. S.D.N.Y. 2006) (noting that the third prong of the Mobile Steel Test is "likely to be moot" because, as it exists today, the Bankruptcy Code specifically provides for equitable subordination); s*ee also Official Comm. of Unsecured*

Creditors of Hydrogen, L.L.C. v. Blomen (*In re Hydrogen, L.L.C.*), 431 B.R. 337, 360–61 (Bankr. S.D.N.Y. 2010) (same). The bankruptcy court must make explicit findings on each of the three elements when granting equitable subordination. *See EEE Commercial Corp. v. Holmes (In re ASI Reactivation, Inc.),* 934 F.2d 1315, 1321 (4th Cir. 1991) (citing *Wilson v. Huffman (In re Missionary Baptist Found. of America, Inc.),* 712 F.2d 206, 212 (5th Cir. 1983)).

32. The most obvious failure of the Committee's allegations is with respect to the first prong—a requirement that the claimant have engaged in inequitable conduct. The Committee alleges only that the actions of the Noteholders and New GM should be imputed to the Nova Scotia Trustee, a statutory representative of GM Nova Scotia appointed well after the alleged inequitable conduct. The Committee cites no precedent for imputing the conduct of third parties to a holder of an independent claim, and for good reason: courts have warned against such imputation to an uninvolved bystander. *See, e.g., Wilson v. Huffman (In re Missionary Baptist Found. of America, Inc.),* 818 F.2d 1135, 1146 (5th Cir. 1987) (differentiating imputation of inequitable conduct from one partner to another, the latter having been involved in all transactions with the former, from imputation to an "uninvolved bystander" where, the Court reasoned, imputation "would be contrary to the principles of equitable subordination as they have developed in the courts").

33. Furthermore, applicable legal precedent is clear that equitable subordination must be applied narrowly and in only the most egregious of circumstances. *In re Enron,* 379 B.R. at 443 ("At bottom, equitable subordination is a drastic and unusual remedy. As a result, it is important to apply section 510(c) narrowly."). The Committee's request to "impute" the conduct of third parties to the Nova Scotia Trustee would only serve to expand the statute to punish an innocent creditor for the alleged conduct of other parties. Since its appointment, the Nova Scotia

Trustee's conduct has been beyond reproach and entirely consistent with its obligations under Nova Scotia law. This Court should not countenance the Committee's attempts to expand this circuit's narrow application of equitable subordination to appease creditors that disapprove of the Debtors' prepetition choice to form a ULC as its financing subsidiary.

34. Having failed to establish inequitable conduct by the Nova Scotia Trustee under the first prong of the test, examination of the other two prongs is unnecessary. However, the third prong of the *Mobile Steel* Test remains informative and an analysis of such prong provides support for allowance of both the Section 135 Claim and the Guarantee Claim. Indeed, courts have generally interpreted the requirement that equitable subordination be consistent with the terms of the Bankruptcy Code to be a "reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives that the result is inequitable." *In re Enron,* 379 B.R. at 434 (citing *Noland,* 517 U.S. at 539, 116 S. Ct. at 1526). Thus, although the Committee believes that allowance of both the Section 135 Claim and the Guarantee Claim would be "inequitable" because such claims provide multiple, yet different ultimate avenues of recovery on the Nova Scotia Notes, there is no legal basis for either claim to be disallowed.

3. The Lock Up Agreement Does Not Constitute an Unauthorized 9019 Settlement

35. Further evidencing the specious objections that the Committee has to the allowance of the Section 135 Claim and the Guarantee Claim, the Committee argues that the Lock Up Agreement constitutes an unauthorized Bankruptcy Rule 9019 settlement.[7] In support of this argument, the Committee complains of four specific actions: (i) the Noteholders' passing an extraordinary resolution which prevented subsequent automatic termination of the prepetition

[7] The Committee does not explain how an unauthorized 9019 settlement would entitle the Committee to use 502(d) to defeat either the Guarantee Claim or the Section 135 Claim.

Lock Up Agreement, (ii) GM Nova Scotia's payment of the Consent Fee, (iii) GM Nova Scotia's release of the Intercompany Loans, and (iv) GM Nova Scotia's consent to entry of a bankruptcy order. Each action complained of fails to pose an issue under Bankruptcy Rule 9019 for two reasons. First, by its terms, the Lock Up Agreement was consummated prepetition and the actions complained of were taken *in furtherance* of, instead of in implementation thereof. Second, and more important, each action was taken by a *non-debtor* and, thus, is not subject to Bankruptcy Rule 9019. Accordingly, the Committee's argument that the Lock Up Agreement is an unauthorized 9019 settlement must fail.

4. Application of the Consent Fee to Principal is Inappropriate, but in Any Case Would Not Impact the Section 135 Claim

36. The Committee does not, and cannot, provide any legal support for its demand that the Court apply the Consent Fee to the principal amount outstanding on the Nova Scotia Notes. Such an unprecedented remedy is inappropriate and unwarranted where the Debtors, sophisticated parties represented by able counsel, aware of all relevant facts and supported in the negotiation by the United States and Canadian governments, participated in good faith negotiations with the Debtors' creditors. It was in this context that the Lock Up Agreement was struck, with the Debtors specifically agreeing that the Consent Fee was not payment on principal and may not be treated as such.

37. However, in the unlikely event that the Noteholders are stripped of the negotiated-for Consent Fee, the Intercompany Loan from GM Nova Scotia to GM Canada would be automatically reinstated and deemed immediately due and payable in the full amount due on the Nova Scotia Notes. In such circumstance, the Nova Scotia Trustee would have two avenues to satisfy its obligations (the Intercompany Loan and the Section 135 Claim) and the Nova Scotia Trustee would receive a 100% recovery on its claims as opposed to the impaired recovery it will

receive under Old GM's plan of reorganization. What appears to be lost on the Committee, however, is that if the Intercompany Loan is reinstated, GM Nova Scotia would benefit from access to additional assets; and as a result, the value of New GM stock—the consideration for all unsecured creditors in the Debtors' chapter 11 cases—would be diminished by the draw on the assets of GM Canada. Thus, it is not in the best interests of the creditors' of Old GM to disallow or recharacterize the Consent Fee.

C. The Committee's Request for Relief Under Federal Rule of Civil Procedure 60(b) and Bankruptcy Rule 9024 is Inappropriate and Should Be Rejected

38. Finally, the Committee's request under Rule 60(b) of the Federal Rules of Civil Procedure ("**Rule 60(b)**") and Rule 9024 of the Federal Rules of Bankruptcy Procedure ("**Rule 9024**") to void limited portions of the *Order (I) Authorizing Sale of Assets Pursuant to Amended and Restated Master Sale and Purchase Agreement with NGMCO, Inc., a U.S Treasury-Sponsored Purchaser; (II) Authorizing Assumption and Assignment of Certain Executory Contracts and Unexpired Leases in Connection with the Sale; and (III) Granting Related Relief* (Docket No. 2968) (the "***Sale Order***") for its own benefit is inappropriate and should be rejected. As an initial matter, even if the Court were to entertain this request—which it should not—it would do nothing to eliminate the Nova Scotia Trustee's claim because the Section 135 Claim is statutory and, as such, valid irrespective of any modification to the Sale Order.

39. Additionally, the Nova Scotia Trustee joins in the arguments set forth in the Noteholders' Response that (i) the Committee's Rule 60(b) application is untimely; (ii) the Committee has totally failed to allege the requisite "exceptional circumstances," "good cause," or "highly convincing evidence" necessary to obtain relief under Rule 60(b); and (iii) application of Rule 60(b) would result in "undue hardship" on a variety of parties.

40. Finally, the Nova Scotia Trustee further opposes this relief due to the implications it could have to the value of New GM stock. The Lock Up Agreement—which the Committee seeks to undo—is a central cog in the larger structure that allowed the 363 Sale to New GM to close, ensure the continued viability of General Motors and provide substantial consideration in the form of New GM stock to creditors of the Debtors' estates. Undoing the Sale Order now would jeopardize New GM's ability to move forward, and thereby represents a serious risk to the value of New GM's stock and the recoveries for all creditors of the Debtors' estates.

CONCLUSION

WHEREFORE, for all of the foregoing reasons, the Nova Scotia Trustee respectfully requests that the Court (i) overrule the Objection; (ii) allow the Section 135 Claim in its entirety and (iii) grant the Nova Scotia Trustee such other and further relief as this Court deems just, proper and equitable.

Dated: December 13, 2010

Respectfully Submitted,

/s/ Philip C. Dublin

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Trustee of General Motors Nova Scotia Finance Company

Exhibit A

EXHIBIT A

2009

Hfx No. 318069
Hfx No. 318077
Hfx No. 318078

SUPREME COURT OF NOVA SCOTIA

IN BANKRUPTCY AND INSOLVENCY

IN THE MATTER OF THE BANKRUPTCY OF GENERAL MOTORS NOVA SCOTIA FINANCE COMPANY

BANKRUPTCY ORDER

Sgd.
GRPM, J. **BEFORE THE HONOURABLE JUSTICE GERALD R.P. MOIR IN CHAMBERS:**

ON THE APPLICATIONS of Aurelius Investment, LLC, Drawbridge DSO Securities LLC, Drawbridge OSO Securities LLC, FCOF UB Securities LLC, Appaloosa Investment Limited Partnership I, Palomino Fund Ltd., Thoroughbred Master Ltd., and Thoroughbred Fund LP (collectively the "Applicants"), each a creditor of General Motors Nova Scotia Finance Company, of the City of Halifax, in the Province of Nova Scotia, filed on October 8, 2009,

UPON READING the Applications for Bankruptcy Order of the Applicants, the Affidavits of Truth of Statements in Application sworn by Dan Gropper, Constantine M. Dakolias, and James E. Bolin, the Affidavit of Nathan Cheifetz, the Consent of Green Hunt Wedlake Inc., and the Consent of General Motors Nova Scotia Finance Company, and upon hearing counsel for the Applicants, and it appearing to the Court that the following acts of bankruptcy have been committed within the six months next preceding the filing of this Application:

(a) General Motors Nova Scotia Finance Company has ceased to meet its liabilities generally as they become due.

1. **THE COURT ORDERS** that the time for giving notice of the applications brought by the Applicants be and is hereby abridged so that each such application is properly returnable today.

*00396/0196/1072344v5

2. **THIS COURT FURTHER ORDERS** that each of the applications brought by the Applicants be and is hereby consolidated into one application pursuant to Section 43(4) of the *Bankruptcy and Insolvency Act*.

3. **THIS COURT FURTHER ORDERS** that General Motors Nova Scotia Finance Company, carrying on business at Purdy's Wharf Tower II, 1300-1969 Upper Water Street, in the City of Halifax, in the Province of Nova Scotia, be adjudged bankrupt by virtue of a Bankruptcy Order hereby made on this date.

4. **THIS COURT FURTHER ORDERS** that Green Hunt Wedlake Inc. of 7001 Mumford Road, Suite 315, Tower 1, Halifax, Nova Scotia, B3L 4N9, be appointed as Trustee of the estate of the bankrupt.

5. **THIS COURT FURTHER ORDERS** that the costs of the Applicant be paid out of the estate of the bankrupt on taxation of the estate.

6. **THIS COURT FURTHER ORDERS** that the Trustee give security in cash or by bond without delay in accordance with Section 16(1) of the *Bankruptcy and Insolvency Act*.

DATED at Halifax, this 9th day of October, 2009.

Sally LeRue
Deputy Registrar

IN THE SUPREME COURT
COUNTY OF HALIFAX, N.S.

I hereby certify that the foregoing is a true copy of the original order on file herein.

Dated the 9th day of October
A.D., 20 09

DEPUTY REGISTRAR

Exhibit B

The Nova Scotia Unlimited Liability Company: Surf and Turf

*Barry D. Horne**

McInnes Cooper, Halifax. BComm (1986) Dalhousie University; LLB (1989) Dalhousie Law School. Member of the Board of Governors of the Canadian Tax Foundation.

Abstract

The author summarizes the corporate law on the Nova Scotia unlimited liability company (NSULC) and describes the proposals to improve that law (for example, adopting the Business Corporations Act approach to amalgamations as an alternative to the court process). The NSULC is compared with the new Alberta unlimited liability corporation, and the relative strengths and weaknesses of each of the entities are highlighted. Finally, the unlimited liability company is analyzed from a US income tax perspective. The author describes how the unlimited liability company is used, with particular emphasis on why its characterization from a US income tax perspective facilitates cross-border planning.

Keywords Unlimited liability; check-the-box; cross-border; hybrids; United States.

The reports of my death are greatly exaggerated.

Mark Twain (1835-1910)

Introduction

The purpose of this paper is not to exhaustively discuss the US check-the-box rules or the company law governing the Nova Scotia unlimited liability company (NSULC).[1] The paper begins with a brief outline of the history of the Companies Act.[2] The discussion of Nova Scotia company law is limited to the developments in the law since the publication of Paul Festeryga's paper in an earlier conference report[3] and to the material differences between the NSULC and the Alberta unlimited liability corporation (AULC) (both their advantages and their

* I would like to express my gratitude to Jamshed J. Patel of the Milwaukee office of Foley & Lardner LLP for his very helpful comments on the US tax components of this paper; to my colleague Mike Simms for his contribution to the corporate section of the paper; and to my colleagues André Gallant and Laurie Jones for their assistance. Any omissions or errors are solely my own.

disadvantages). In the course of that discussion, some statements about Nova Scotia corporate law in recently published articles comparing the NSULC and the AULC will be corrected. Finally, the ULCs will be discussed from a tax perspective—in particular, the meaning of "unlimited liability" in the check-the-box rules; how transactions with a ULC may have unplanned US tax consequences; and examples of transactions involving the use of a ULC (principally, inbound planning with some discussion of outbound planning). The last part of this paper has a heavy US income tax component, with commentary on some Canadian income tax issues. An understanding of the US components is important to ensure that the Canadian advice is sensitive to the US tax planning.

Description of the Company Law

A Brief History of the NSCA

The first statute governing the incorporation of companies in Nova Scotia was enacted in 1862[4] and was modelled largely on the federal legislation of 1854, which in turn was largely borrowed from the legislation then in place in New York.[5] The JSCA (1862) provided for the incorporation of two different types of companies—the "double liability company" and the "unlimited liability company."

A double liability company was incorporated by five or more people filing a declaration with the office of the Provincial Secretary and with the Registrar of Deeds for the county where the company's place of business was to be situated. Every member of such a company was personally liable, during membership and for a period of six months after the filing of the certificate of transfer of his or her shares, for the debts and liabilities of the company "up to an amount equal to double the stock held by him, deducting therefrom the amount actually paid to the company on such stock." Such companies could neither remain in existence beyond the year 1875 nor be incorporated for the purposes of banking, insurance, or ordinary mercantile and commercial business.

An unlimited liability company was incorporated by three or more people filing a similar declaration. However, the declaration had to contain a statement that the members did not seek limited liability. Accordingly, the members of such a company had personal liability for all debts and undertakings of the unlimited liability company. Unlike the double liability company, an unlimited liability company could be incorporated "for any lawful purpose or business" and did not have any limit on the duration of its existence. Thus, even under the earliest Nova Scotia statute for the incorporation of companies, it was possible to incorporate both a limited liability company and an unlimited liability company.

The JSCA (1862) was not commonly used and was eventually repealed in 1883 upon the enactment of the Nova Scotia Joint Stock Companies Act,[6] which was largely copied from the act in force in Ontario at the time.[7] Incorporation under the NJSCA (1883) was by letters patent granted by the governor in council. Five or more persons could petition the governor in council for a charter constituting

them and any others who joined "a body corporate and politic for any purpose or objects to which the legislative authority of the Parliament of Nova Scotia extends, except the construction and working of railways and loan companies." A company incorporated under the NJSCA (1883) had a legal personality (separate and distinct from its members) and perpetual existence, and the shareholders had limited liability.

In 1900, a new Nova Scotia Companies Act[8] was passed, which reverted to the English-style registration system in which incorporation was achieved by the registration of a memorandum of association and articles of association, as opposed to the previous letters patent system. The NSCA (1900) was modelled largely after the legislation in England—the Companies Act, 1862,[9] as amended to 1900.[10] The NJSCA (1883) and the NSCA (1900) were in force concurrently until 1902, when a statute was passed prohibiting the granting of any more letters patent under the NJSCA (1883).[11]

Since 1900, with the exception of companies incorporated by special statute, all companies incorporated in Nova Scotia have been incorporated by registration of a memorandum of association and articles of association.[12] One important aspect of the Nova Scotia model of incorporation, unlike the BCA model, is that it is effectively contractual in nature. (In some respects, the Nova Scotia company is similar to a Delaware limited liability company, which is governed by a limited liability company agreement, also referred to as an operating agreement.) The NSCA is not intended to be a complete code of corporate law. The law that governs a Nova Scotia company (including an NSULC) is a combination of statute and jurisprudence.[13] This important distinction between BCA statutes and the NSCA helps to explain why statutory principles of interpretation applicable to the interpretation of a BCA statute do not necessarily apply to the NSCA.

Types of Companies That Can Be Formed Under the NSCA

Three different kinds of companies can be formed under the NSCA: (1) companies limited by shares, (2) companies limited by guarantee, and (3) NSULCs. Companies limited by shares must have share capital, whereas companies limited by guarantee and NSULCs may or may not have share capital (although in virtually every case an NSULC will have share capital).

The Nature of an NSULC

An NSULC is, for Canadian corporate law purposes, like any other company: it is a separate legal entity with perpetual existence and with the powers of a natural person (unless limited by its memorandum of association); however, the members of an NSULC do not have limited liability for the debts and obligations of the company, unlike the shareholders of most other Canadian companies (with the exception of the shareholders of an AULC).

The main difference between an NSULC and a company limited by shares (or a company limited by guarantee) is that the liability of the members of an NSULC for the debts and liabilities of the company on a winding up is unlimited. The NSCA contains a number of provisions that apply only to companies limited by shares. For example, the reduction of capital of a company limited by shares must be approved by a special resolution of the shareholders and confirmed by the court.[14] Accordingly, an NSULC may resolve to return paid-up capital to its shareholders in the manner provided for in its articles of association without court approval.[15]

Generally speaking, the sections of the NSCA applicable only to companies limited by shares were originally inserted to protect those people who deal with such companies and to give those companies the powers that they were restricted from exercising as a consequence of jurisprudence. For example, in the case of a return of paid-up capital, it was ultra vires a company limited by shares to return paid-up capital, on the theory that those dealing with such companies relied upon the statement in the memorandum of association as to the capital of the company; there was no recourse to the members if the company was ultimately unable to meet its obligations.[16] The paid-up capital restriction imposed by the courts was relaxed by an amendment to the UK legislation permitting a return of paid-up capital so long as, among other things, it was approved by the court.

On the other hand, the creditors of an unlimited liability company could, upon a winding up, look to the company's members if it was unable to satisfy its obligations; thus, the common-law restriction on reducing paid-up capital was not applicable to an unlimited liability company, and the enactment of any statutory relief was therefore unnecessary.[17]

The Nature of Unlimited Liability

The NSCA defines the liability of the members of a Nova Scotia company as follows:

> In the event of a company being wound up, every present and past member shall, subject to this Section, be liable to contribute to the assets of the company to an amount sufficient for payment of its debts and liabilities and the costs, charges, and expenses of the winding up and for the adjustments of the rights of the contributors among themselves.[18]

An exception is made for companies limited by shares. A member of such a company will not be required to contribute any amount in excess of the amount, if any, unpaid on the shares in respect of which such member is liable (there is a similar limit for companies that are limited by guarantee, the limit being the amount that the members agree to guarantee).

The liability of a past member of an NSULC is limited to a period of one year after the member ceases to be a member, and liability does not extend to any

debts or liabilities contracted after the member ceases to be a member. Furthermore, before approaching a past member, a liquidator will first require the current members of an NSULC to contribute to the payment of the NSULC's debts and the costs of the winding up.

The members of an NSULC are not directly liable to the NSULC's creditors. The liability of a past or present member of an NSULC is crystallized only when the NSULC's creditors petition the court for a winding-up order (or when the NSULC becomes bankrupt) and the company's debts and liabilities have not been satisfied. In such a case, the past or present member (if liable) owes the amount to the NSULC, not to the creditor. The liquidator will collect those amounts from the past and present members, and those amounts will be available to satisfy the claims of the creditors against the NSULC.

Care should be taken when incorporating an NSULC or converting an existing company into an NSULC to ensure that an appropriate intermediary is interposed between a shareholder with assets and the NSULC (this is usually accomplished by making the direct shareholder of the NSULC a trust, a US shell company, or a limited partnership), so that in the event of the winding up of the NSULC the shareholder who is exposed to liability will not have material assets that can be called upon to satisfy the debts and liabilities of the NSULC. The timing of the interposition of the intermediary is very important in the case of a conversion of a company into an NSULC when one is using the arrangement method. The timing issue is discussed in greater detail below.

Lenders and others who take a pledge of shares in the capital of an NSULC must ensure that they will not be considered shareholders of the NSULC in the event that it is wound up. In the context of a pledge of shares, the legal title in the shares should not be transferred to the pledgee to create a charge, and the pledgee (or an affiliate) should not consent to become a member of the NSULC without taking a deliberate action within its control. The pledgee should not be a member if it merely takes possession of the share certificate(s) of the NSULC endorsed for transfer in blank, and is not entered on the register of members. The pledge agreement should be carefully reviewed and should contain language sufficient to ensure that the pledgee does not, by entering into the agreement, have the immediate right to be entered on the register of members.

Incorporation of an NSULC

A new NSULC may be incorporated in the same way as any other company under the NSCA. There are no special requirements for the incorporation of an NSULC. Essentially, the memorandum of association and articles of association are prepared and filed with the Registrar of Joint Stock Companies (Nova Scotia) ("the registrar"), together with a statutory declaration stating that all of the requirements of the NSCA have been met. The registrar then issues a certificate of incorporation for the company, which is deemed to be incorporated from the date shown on the certificate.

Conversion of an Existing Company into an NSULC

There are essentially two ways to convert an existing company into an NSULC without using a dissolution. Both of these methods require, as a prerequisite, that the company be a Nova Scotia company. Thus, a preliminary step in both cases, if the existing company is incorporated in another jurisdiction, is to continue the company into Nova Scotia as a company limited by shares. The NSCA, unlike the Alberta Business Corporations Act (ABCA),[19] does not permit the direct continuance of a company into Nova Scotia as an NSULC. This is a fairly routine matter when one is continuing a company from another Canadian jurisdiction, and a little more complex when one is continuing a limited liability company or corporation from the United States. A continuance from a Canadian province can usually be accomplished in a few days (assuming that there are no complications in the exporting jurisdiction). One of the preliminary steps prior to continuance is to ensure that any contributed surplus in the company is first capitalized into stated capital to the extent that it does not give rise to any Canadian income tax consequences.[20]

In order to become an NSULC, a company limited by shares may amalgamate with a shell company (which may be either a company limited by shares or an NSULC). The amalgamation agreement provides that the amalgamated company will be an NSULC. The process involves the companies entering into an amalgamation agreement, which is then approved by the members of each company. An application is then made to the Supreme Court of Nova Scotia for an order approving the amalgamation agreement. Once the order is obtained, a copy of the order, together with the amalgamation agreement, must be filed with the registrar, who then issues a certificate of amalgamation. Until the amalgamation agreement and order are filed with the registrar, the amalgamation cannot have effect. On and from the date of the certificate of amalgamation, the companies are amalgamated and continue as one company. The amalgamated company possesses all of the property, rights, privileges, and franchises and is subject to all of the liabilities, contracts, and debts of each of the amalgamating companies.

An alternative method of converting a company limited by shares into an NSULC involves the company entering into an arrangement with its members pursuant to section 130 of the NSCA. The company and its members enter into a plan of arrangement whereby the company's memorandum of association is amended to remove the statement that the liability of the members is limited, and to substitute therefor the statement that the liability of the members is unlimited. The name of the company is also changed to replace the words "Limited" or "Incorporated" with one of the following: "Company," "Co.," "Corporation," "Corp.," "Unlimited Liability Company," or "ULC." The memorandum of association and articles of association of the company are then amended and restated to reflect the fact that the company is an NSULC.

The implementation of an arrangement is commenced by an application to the Supreme Court of Nova Scotia for an order directing the calling and holding

of a meeting of the members to consider the arrangement. Once this order is granted, the company calls a meeting of the members as set out in the order (although, commonly, where the company is closely held, the order provides that the approval of the shareholders may be by written resolution).

For the arrangement to be accepted, a majority in number representing three-fourths in value of the members present either in person or by proxy at the meeting must approve the plan of arrangement. If the arrangement is accepted by the required majority of the members, an application is then made to the Supreme Court of Nova Scotia for an order sanctioning the arrangement. If the arrangement is sanctioned by the court, it has no effect until a certified copy of the order is delivered to the registrar for registration. A copy of every such order must be annexed to every copy of the memorandum of association of the company issued after the order has been made.

An amalgamation has the advantage of being a little less time-consuming than an arrangement, provided that creditor consents can be obtained quickly. The disadvantages of an amalgamation compared with an arrangement are that the amalgamation is more expensive (an arrangement avoids the $6,000 ULC tax; creditor consents must be obtained; there is a greater probability of commercial issues;[21] and tax consequences (for example, a deemed year-end) may be triggered.

An arrangement has become the method of choice to convert a company into an NSULC because it is cheaper, it avoids the consequences of an amalgamation, and it avoids the requirement to obtain creditor consents (although there is a theoretical risk that the court may require consents). However, there is a potential liability risk for past shareholders if a company is converted into an NSULC using the arrangement method. If the shareholder wants to interpose an intermediary between itself and the Nova Scotia limited liability company before it becomes an NSULC because of liability concerns, the interposition should occur before the company becomes subject to the NSCA. If the shareholder causes the intermediary to be interposed after the company becomes subject to the NSCA and before it becomes an NSULC, the shareholder may still be subject to unlimited liability as a past shareholder of the NSULC because the company and the NSULC are the same body corporate (the arrangement is, in effect, merely an amendment to the memorandum of association and articles of association). The original shareholder, as a past member of the NSULC, is liable for up to one year for the debts of the company that were in existence at the time it transferred its shares in the company to the intermediary.

Conversion of an NSULC into a Company Limited by Shares

An NSULC can easily be converted into a company limited by shares. Under section 68 of the NSCA, an NSULC can, by special resolution, resolve to register as a company limited by shares. A brief application is then made to the registrar,

who closes the company's registration as an NSULC and opens a new registration for the company as a company limited by shares. The conversion to a limited company does not result in any negative tax consequences, since the company is the same body corporate both before and after conversion.

A Comparison of the NSCA and the ABCA

There are differences between the NSCA and the ABCA because of the origin and unique history of the respective statutes. The following is an overview of some of the major differences between an NSULC and an AULC.

Unlimited Liability

The liability of the members of an NSULC is unlimited. However, the liability of the members of an NSULC does not arise until the NSULC is wound up. The jurisprudence concerning who is a member for the purposes of being added to the list of contributories is well developed. The law is clear on when liability is extended to a past member and on the liabilities of the NSULC for which a past member is responsible. An additional method of dealing with the unlimited liability of being a shareholder of an NSULC is to re-register it as a limited company under section 68 of the NSCA. Arguably, re-registration does not preserve a creditor's rights (this is not the case with an AULC). The shareholders of an AULC also have unlimited liability; it is, however, owed directly to the creditors of the AULC. Presumably, a creditor could pursue a shareholder directly so long as it establishes its claim against the AULC. A number of issues also arise in respect of, among other things, when the liability of a shareholder of an AULC ceases and whether or not a former shareholder of an AULC (or of an Alberta limited corporation that has been converted into an AULC) is liable for the debts of the AULC that arise after it ceases to be a shareholder. The liability concern for a shareholder has also been raised if it ceases to be a shareholder of an Alberta limited corporation and that corporation is subsequently converted into an AULC. These issues are more fully dealt with by Don R. Sommerfeldt in his paper on the AULC.[22]

Authorized Capital

Under the NSCA, the memorandum of association of a company limited by shares must set out, in the case of par value shares, the amount of share capital and the division thereof into shares of a fixed amount.[23] For shares without par value, the total number of shares the company proposes to issue must be specified. The share capital of an NSULC is set out in its articles of association.[24] A Nova Scotia company cannot have an authorized capital consisting of an unlimited number of shares; ABCA corporations may have an unlimited number of shares.

Residence of Directors

There are no residency requirements for directors under the NSCA. Under the ABCA, the general rule is that a minimum of 25 percent of the directors must be resident Canadians; if there are fewer than four directors, at least one director must be a resident Canadian.[25]

No Par Value Shares

The NSCA permits shares to be issued with or without par value, and a company may have both par value and no par value shares.[26] Shares of ABCA corporations are required to be without nominal or par value.[27]

Paid-Up Capital

Under the NSCA, the paid-up capital of shares without par value is the aggregate amount of the consideration paid for their issuance; for shares that have a par value, the paid-up capital is equal to the total par value of the issued and outstanding shares.[28] For an ABCA corporation, the full amount paid for shares must be added to the stated capital account maintained for that class of shares, except where the corporation is permitted by the ABCA to add a lesser amount, such as in the case of a transfer of property to the corporation.[29] The ABCA provides a mechanism to capitalize contributed surplus into paid-up capital; the NSCA does not provide a comparable mechanism. A potential remedy for dealing with the capitalization issue under the NSCA is to undertake an arrangement of the capital of the NSULC. The contributed surplus would be converted into paid-up capital in the course of exchanging the currently issued and outstanding shares, with new shares having an aggregate par value equal to the desired paid-up capital.

Investment in Parent Company

Under the NSCA, a company may hold shares in its parent company. Except in limited circumstances or for a limited period of time (a maximum of 30 days), this is not possible under the ABCA for an Alberta corporation.[30]

Management Powers

The NSCA does not confer management powers on the directors. This is usually done through the articles of association, but it need not be done (some or all of the power to manage the company could be retained by the shareholders, or the shareholders could retain the power to withdraw, from time to time, the power of the directors to manage the company). The ABCA specifically requires the directors to manage, or supervise the management of, the business and affairs of the corporation, subject to any unanimous shareholder agreement.[31]

Dividends

The NSCA does not contain any provisions restricting the declaration and payment of dividends. The only limitation on the declaration and payment of dividends, other than any limitation that may be imposed by the memorandum of association and articles of association of a company, is the common-law restriction that dividends may not be paid out of the capital of the company (such a common-law restriction does not apply to an NSULC). The capital of a company for the purposes of this test is essentially the paid-up capital, and dividends may, subject to the articles of association, be paid out of share premium, contributed surplus, or retained earnings. The ABCA, on the other hand, provides that dividends may be paid only if there are no reasonable grounds for believing that the corporation is (or after the payment would be) unable to pay its liabilities as they become due, or that the realizable value of the corporation's assets would, as a consequence of the payment of the dividend, be less than the aggregate of its liabilities and stated capital of all classes.[32]

Issuance of Shares

Under the ABCA, the consideration for shares may be paid in money or in property or past services that are not less in value than the fair equivalent of the money the corporation would have received had the shares been issued for money.[33] Under the NSCA, shares are deemed to have been issued and to be held subject to the payment of the par value, or subscription price, depending on whether the shares have a par value, in cash, unless otherwise determined by a written contract.[34] A Nova Scotia company can issue shares that are not fully paid, subject to the company's right to call for payment of the unpaid portion. ABCA corporations cannot issue shares that are not fully paid, and cannot accept promissory notes or other promises to pay as consideration for the issuance of shares.[35]

Shareholders' Resolutions

Under the NSCA, a special resolution must be passed by three-fourths of the votes cast by the members entitled to vote who are present at the meeting in person or by proxy. Unless the resolution is unanimously passed, it must be confirmed by a majority of the members entitled to vote at a subsequent meeting.[36] Under the ABCA, a special resolution is required to be passed by a majority of not less than two-thirds of the votes cast by the shareholders who voted on the resolution.[37]

Unanimous Shareholders' Agreements

A shareholders' agreement made among the shareholders of a Nova Scotia company does not have the same status as a unanimous shareholders' agreement under the ABCA. A shareholders' agreement among the shareholders of the Nova Scotia company is not enforceable against the company to the extent that it purports to

restrict the powers of the directors to manage the business of the company if such powers are granted to the directors by the company's articles of association. The constating documents of a Nova Scotia company must be amended to give effect to those provisions in the shareholders' agreement that are otherwise contrary to the articles of association (for example, provisions dealing with the management of the company). The ABCA permits the powers of the directors to be restricted, in whole or in part, by a unanimous written agreement among all of the shareholders.[38]

Amalgamation

Under the NSCA, an amalgamation must be approved by the Supreme Court of Nova Scotia. Under the ABCA, an amalgamation agreement must be approved by a special resolution.[39] The ABCA also provides for vertical and horizontal short-form amalgamations that dispense with many of the formalities of other amalgamations, such as the need for an amalgamation agreement and shareholder approval.[40] The ABCA also permits a triangular amalgamation.

Financial Assistance

The ABCA permits a corporation to provide financial assistance to any person for any reason. However, the corporation must disclose to its shareholders the financial assistance given by the corporation for the purpose of or in connection with the purchase of shares issued or to be issued by the corporation or an affiliated corporation.[41] The NSCA, subject to certain exceptions, prohibits companies from providing financial assistance, whether directly or indirectly, and whether by means of a loan, a guarantee, the provision of security, or otherwise 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.[42]

Duties of Directors

The ABCA imposes an objective test with respect to the duty of care of directors, who are required (1) to act honestly and in good faith with a view to the best interests of the corporation, and (2) to exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances.[43] In Nova Scotia, the common-law duty of care (a subjective test) applies; further, section 153 gives the court discretion to relieve a director in certain cases if he or she has acted honestly and reasonably.

Liability of Directors

The liabilities imposed on directors are generally more onerous under the ABCA than they are under the NSCA.[44] The NSCA does not address the liability of

directors in an organized manner; however, several miscellaneous provisions impose liability on directors, including sections 39(2), 40(2), 42(2), 55(2), 65, 111(2), and 116(3).

Amendment of Authorized Capital

Under the NSCA, a company may increase its authorized capital, including by means of the creation of a class of shares (or other changes to its authorized capital) by shareholder resolution. Although notice to the registrar is required, the change is effective when the resolution is passed (that is, there is no formal filing requirement to give effect to the change).[45] However, under the ABCA, a change to the authorized capital is not effective until articles of amendment are filed and a certificate of amendment is issued by the registrar.

Revival

The NSCA allows a company to voluntarily surrender its certificate of incorporation and be dissolved,[46] but it does not allow a company dissolved in this manner to be revived. The ABCA allows any corporation to be revived, even if it was voluntarily dissolved.[47]

Return of Capital

Under the ABCA, a corporation may reduce its stated capital with the approval of a special resolution if the applicable solvency test is met.[48] A corporation can thereby distribute an amount not exceeding the stated capital of a class or series of shares to the holders of shares of that class or series. A court application is required to return capital to the shareholders of a Nova Scotia company limited by shares;[49] however, an NSULC may resolve to return paid-up capital to its shareholders in the manner provided for in its articles of association.[50]

Formation of a ULC

Under the ABCA, an AULC can be formed by incorporation, by amalgamation, by an amendment to the articles of incorporation, or by continuing an existing company (either limited or unlimited) from another jurisdiction under the ABCA as an AULC.[51] Under the NSCA, an NSULC can be formed by incorporation, by amalgamation, or by an amendment to the memorandum of association of a Nova Scotia company limited by shares through an arrangement. A company formed outside Nova Scotia cannot be directly continued under the NSCA as an NSULC; the company must first be continued as a limited company and then converted into an NSULC by amalgamation or by an amendment to its memorandum of association.

Cost

The taxes paid to the Nova Scotia government for the incorporation of an NSULC are $6,000 in the first year and $2,000 every year thereafter; for the conversion of a company into an NSULC using an amalgamation, $6,000 in the first year and $2,000 every year thereafter; and for the conversion of a company into an NSULC using an arrangement, $235 in the first year and (depending on the renewal date) $2,000 every year thereafter. The cost of incorporating an AULC is $100; the cost of converting a company into an AULC by an amalgamation or an amendment is the same. No fees are payable to the Alberta government in respect of the AULC to maintain its existence in subsequent years.

Proposals for Amendments to the NSCA

Service Nova Scotia and Municipal Relations (a department of the Nova Scotia government) has recently indicated that it is considering amendments to the NSCA. To this end, it solicited comments from corporate law practitioners in the province and then commissioned a discussion paper entitled *Proposals for Amendments to the Nova Scotia Companies Act*.[52] The proposals were released for public comment on October 23, 2005.

The following is an overview of some of the relevant proposed amendments. The amendments were neither proposed by nor sanctioned by Service Nova Scotia and Municipal Relations or any other arm of the Nova Scotia government, and it is uncertain at this point whether or when they will result in amendments to the NSCA.

Amalgamations

The current amalgamation procedure, under which an application is made to the Supreme Court of Nova Scotia for approval of an amalgamation agreement, should be retained because of its flexibility. However, it has also been proposed that a supplementary alternative procedure, which mirrors that found in BCA-style statutes, be adopted. The alternative procedure provides for an amalgamation to be effected by a special resolution of each company, or by a directors' resolution if the companies are related, and the filing of an amalgamation agreement to which is attached the memorandum and articles of association of the proposed amalgamated entity together with a statutory declaration of an officer or director of each company indicating that the company is able to meet a solvency test on amalgamation and that creditors of each company either are not prejudiced by the amalgamation or have been notified of the proposed amalgamation and have not objected. This alternative procedure would streamline simple amalgamations and reduce the time and cost of such transactions. The benefit of retaining the existing procedure is that companies could be amalgamated even if they did not technically satisfy a BCA-style solvency test.

Conversion

An existing Nova Scotia company limited by shares should be permitted to convert to an NSULC by altering its memorandum of association through a unanimous resolution of its members (rather than using the more complex arrangement procedure to accomplish this result); it should then be able to re-register as an NSULC. Furthermore, it has been proposed that a company continuing into Nova Scotia be permitted to elect to become an NSULC upon continuance. These proposals would greatly reduce the time and cost of creating an NSULC: they would dispense with the artifice of an amalgamation with a shell company and the arrangement process, both of which are costly and time-consuming relative to the proposed methodologies.

Reduction in Capital

Currently, a company limited by shares must receive court approval to reduce its capital. Other jurisdictions in Canada address this process by placing statutory restrictions on when capital may be reduced, by providing creditor remedies in the event that capital is distributed contrary to the legislated criteria, and, alternatively, by use of the oppression remedy in cases where the conduct of the majority of the shareholders of the company is oppressive or unfairly prejudicial to the interests of minority shareholders. It has been proposed that the current sections of the NSCA dealing with the reduction of capital be repealed and replaced with a solvency test coupled with a provision that the shareholders of a company that reduces its capital in contravention of the NSCA be compelled to repay the amount. The statutory language concerning the purchase for cancellation or redemption of shares in a company that is an NSULC should be modified so that it is clear that those provisions do not apply to an NSULC.

Restoration

The NSCA currently provides for the restoration of a company struck off the register upon application to the court. The proposals recommend that the NSCA be amended to permit the application for restoration to be made to the registrar; once restored, the company would be continued as if it had never been struck off. The proposals also recommend that the Corporations Registration Act be amended to permit the registrar to determine that the certificate of registration under the legislation be deemed not to have been revoked in the context of the restoration of a struck-off company. The proposals provide for a mechanism whereby the decision of the registrar concerning the restoration of a struck-off company be subject to review by the court upon application by any aggrieved person.

Alteration of Memorandum

Under the NSCA, a company may not alter its memorandum of association except as specifically provided for therein. Some of those alterations require

court approval or an arrangement. The proposals recommend that an amendment to the memorandum be approved by special resolution, except in the case of a conversion to an NSULC, in which case the approval must be unanimous.

Financial Assistance

Under the proposals, the financial assistance provisions set out in section 110(5) of the NSCA would be repealed; the restriction on financial assistance given by a company for the purpose of, or in connection with, the acquisition of shares in the company's capital would be removed and replaced with an express statement that financial assistance is permitted.

Paid-up Capital on Continuance

The proposals recommend that the NSCA be revised to include a provision confirming that the paid-up capital of a class of shares of a company continued under the NCSA be the same as the paid-up capital or the stated capital, as the case may be, of the company in the exporting jurisdiction. This provision is similar to provisions in most BCA jurisdictions, and would create greater certainty as to the amount of the paid-up capital of a company upon continuance.

Unlimited Share Capital

The proposals recommend that the number of shares of a class of shares in the capital of a Nova Scotia company be permitted to be unlimited.

Special Resolutions

The proposals recommend that the threshold for passing a special resolution be reduced from three-quarters to two-thirds and that the requirement for a confirmatory meeting (in the case of an actual meeting) be removed.

Characterization of the ULC from a US Tax Perspective

The Canadian Versus the US Approach to Entity Characterization

The determination of whether or not an entity (to use the term loosely) is a corporation[53] or a partnership[54] for Canadian income tax purposes involves the application of Canadian non-tax legal principles. In the United States, however, the characterization of an entity as an association, partnership, or disregarded entity depends on the rules set out in the Internal Revenue Code[55] and the regulations issued thereunder.

The US Approach to Entity Characterization

Prior to the check-the-box regulations, the test for the characterization of an entity for federal tax purposes depended upon the application of a six-factor test ("the Kintner rules") that had its genesis in US case law.[56] Only four of those factors were relevant for the purpose of determining whether or not an entity was a partnership or an association. Under the Kintner rules, an NSULC was determined to be an entity that could be treated as either a partnership or an association, depending on whether or not it failed at least two of the four tests (limited liability, centralization of management, free transferability of interests, and continuity of life). If an entity did not satisfy at least two of the four tests, it would be treated as a partnership.

In a private letter ruling dealing with the classification of an NSULC as a partnership, the Internal Revenue Service (IRS) made the following comments concerning whether or not a member of an NSULC had limited liability:

> An organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization. Section 301.7701-2(d)(1).
>
> Section 135 of the Companies Act provides that during wind up the members of an unlimited company are liable to contribute to the company's assets in an amount sufficient for the payment of its liabilities together with the expense of winding up.
>
> Z's Memorandum of Association states that Z is an unlimited company. Therefore, Z's members are liable to contribute an unlimited amount to pay Z's liabilities when Z is wound up. Thus, Z does not have the corporate characteristic of limited liability.[57]

Clearly, the IRS believed that a member of an NSULC did not have limited liability within the meaning of the Kintner rules. Presumably, the IRS did not interpret Treasury regulation section 301.7701-2(d)(1), as it then read under the Kintner rules,[58] as requiring a member to have a direct liability to the creditor notwithstanding that the language of the provision suggested otherwise.[59] Under the NSCA, a member (or a past member in certain circumstances) has a liability to the NSULC, not to its creditors.

The check-the-box rules, for the purposes of Canadian entities, effectively simplified the rules for the characterization of a Canadian corporation or company[60] by focusing solely on whether or not the members had unlimited liability and, if they had unlimited liability, the number of members. The approach taken by the Treasury in the check-the-box rules was to first classify a corporation and company in Canada as a corporation,[61] subject to the exception, which originally read, "with regard to Canada, any corporation or company formed under any federal or provincial law which provides that the liability of all of the members of such corporation or company will be unlimited," and was subsequently reworded to read, "with regard to Canada, a Nova Scotia unlimited liability company (or

any other company or corporation, all of whose owners have unlimited liability pursuant to federal or provincial law)."[62] The reason for the subsequent amendment to the exception was explained by the Treasury as follows:

> These regulations also clarify the exception to per se corporate treatment for Canadian companies and corporations. When the final check-the-box regulations were promulgated, the only company or corporation that could be formed where the liability of all of its members was unlimited pursuant to any federal or provincial statute (as opposed to through side agreements of the members), was a Nova Scotia Unlimited Liability Company (NSULC). However, in order to avoid changing the regulations if any other province, or the federal government, subsequently allowed for the formation of unlimited liability companies by statute, these regulations did not specifically list the NSULC. In response to questions from taxpayers, the regulation is clarified, with effect from January 1, 1997, by specifically naming the NSULC, while still providing for any other unlimited liability company that might subsequently be allowed by any other federal or provincial statute.[63]

Meaning of "Unlimited Liability"

As explained above, an NSULC and federally and provincially incorporated companies (or corporations) whose members have unlimited liability are "eligible entities" (that is, they can elect their classification for US tax purposes). Unfortunately, there is no definition of "unlimited liability" for the purposes of determining whether or not a federally or provincially incorporated corporation or company is an eligible entity.

The only definition concerning the liability of a member is the definition of limited liability for the purposes of determining the default classification of what is otherwise an "eligible entity." The definition of limited liability is, practically speaking, not relevant in its application to a Canadian corporation or company because the definition is not applicable unless the corporation or company is an "eligible entity," which would mean that a determination would first have to be made that the shareholders have "unlimited liability." Nevertheless, the definition may provide some guidance on the meaning of unlimited liability.

For the purpose of determining whether or not a person has limited liability for the purpose of the default classification rules, a member of a foreign eligible entity is treated by Treasury regulation section 301.7701-3(b)(2)(ii) as having limited liability if

> the member has no personal liability for the debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law pursuant to which the entity is organized, except that if the underlying statute or law allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational

> documents may also be relevant. For the purpose of this section, a member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such. A member has personal liability for the purpose of this paragraph even if the member makes an agreement under which another person (whether or not a member of the entity) assumes such liability or agrees to indemnify that member for any such liability.

The definition of limited liability (albeit for the purposes of the default classification rules) is effectively the definition used in the Kintner rules to determine the status of a ULC as either a partnership or a corporation. The definition may be construed broadly on the basis of the above-noted hypothesis that a person does not have limited liability if the corporate debts are not limited to the corporation's assets. In light of the previous rulings, the definition of limited liability, and the genesis of the original meaning of limited liability, the conclusion should be that a Canadian corporation or company will be an "eligible entity" so long as the liability of the shareholders for the liabilities of the corporation or company is either indirect (as in the case of an NSULC) or direct (as in the case of an AULC).

Different Characterizations Under the Check-the Box Rules

In effect, a ULC can be treated as an association, a partnership, or a disregarded entity. If a ULC has only one member,[64] unless it elects to be treated as an association it will be disregarded as an entity separate from its owner. More particularly, the ULC's activities are treated as if the ULC were a sole proprietorship, branch, or division of the owner.[65] If the ULC is treated as a partnership and does not elect to be treated as a corporation, the ULC is a partnership for US tax purposes; thus, for the most part, transactions between it and its members are not ignored. The fictions created by the check-the-box election are important for the purposes of determining how the ULC assists with Canada-US tax planning.

Change in Classification Without Election

In some cases, a client will establish a ULC and not seek US advice regarding a change in the entity or a transaction that may affect the number of its members or the way its assets are held. In those cases, there could be adverse US income tax consequences. For example, if a US corporation (USco) enters into a joint venture with a Canadian corporation (Canco) whereby USco acquires 25 common shares and Canco acquires 75 common shares, the ULC will be treated as a foreign partnership so long as it does not check the box to be treated as a corporation. If the ULC subsequently transfers its business to another Canadian company that is not a ULC for shares, or if it acquires a Canadian company that is not a ULC with

significant assets or earnings, the original check-the-box planning will be affected. USco should ensure that there are sufficient covenants in the constating documents or shareholders' agreement for the ULC to ensure that such transfers or acquisitions will involve ULCs and not Canadian limited companies.

Another example is the case where there is an increase in the number of members of a ULC that is treated as a disregarded entity. If another person becomes a member of the ULC, the ULC will cease to be a disregarded entity and will be treated as a partnership for US tax purposes.[66] The consequences of a change in the number of members of a limited liability company (LLC) from a disregarded entity to a partnership is described in Revenue ruling 99-5.[67]

In Revenue ruling 99-5, the IRS considered the consequences of a single-member LLC becoming a partnership in two situations: the new member ("B") (1) acquiring 50 percent of the interest in the LLC from the original member ("A"), and (2) subscribing for a 50 percent interest in the LLC. In the case of a purchase, A is treated as selling 50 percent of its interest in the assets of the LLC to B and therefore recognizing the associated gain on its 50 percent interest in those assets. A and B are then treated as contributing those assets to the LLC, a partnership, with A having a cost in its partnership interest equal to its original cost in the assets that it is treated as having retained and B having a cost equal to the amount that it paid to A for its interest in the LLC. The subscription by B for a 50 percent interest in the LLC is treated as a contribution of assets to a partnership on a tax-deferred basis without any income recognition by A. Although this Revenue ruling dealt with an LLC, the same analysis should be equally applicable to a ULC, even though the ULC would be treated as a foreign partnership (rather than as a domestic partnership) for US tax purposes. Accordingly, the consequences of an investment in a ULC that is disregarded must be carefully considered when the effect of the investment is to cause the ULC to be treated as a partnership (an entity) for US tax purposes.

Another example of the negative tax consequences flowing from a ULC changing from a disregarded entity to a partnership is the case where the ULC owes money to its member.[68] Even though the debt is disregarded for US tax purposes, it is an obligation that exists under commercial law. The conversion caused by the addition of members is treated from a US tax perspective, as outlined above, as a sale of assets (if there is a sale of a portion of the member's interest) and a contribution of assets by both the original member and the new member to a partnership. Prior to the contribution, the debt owed to the original member is ignored; however, after the contribution, the partnership is treated as owing that amount to the original owner, since a partnership is recognized as an entity. In the end, the original member is treated as contributing the assets to a partnership (the ULC) in exchange for a partnership interest and boot. Subject to certain exceptions,[69] the original member is treated as selling a portion of the assets for the note. (The income inclusion is not dependent on whether or not the amount of the debt exceeds the member's basis in the assets of the ULC.) Accordingly, even though from a Canadian income tax perspective there may not be any tax

consequences when another member subscribes for shares in the ULC, there may be a US income tax liability.

Uses of the ULC

Flowthrough of Losses

A US person cannot claim a loss realized in Canada as a deduction against its other income unless the loss is realized either directly or indirectly through a partnership.[70] If the US person desires to carry on that business through a corporation for Canadian tax purposes, the ULC could be the vehicle of choice, since, in the case of a disregarded entity, the loss will be treated as its own or, in case of a partnership, the US person will be able to deduct its share of the loss of the ULC from its income (applying US tax rules for partnerships). Loss planning using an NSULC may be preferred over planning using an AULC if a "liability blocker" between the ULC and the US shareholder defeats the US tax planning.[71]

Nevertheless, consideration must be given to the dual consolidated loss (DCL) rules.[72] The purpose of the DCL rules is to prohibit a "dual consolidated loss" from offsetting the taxable income of a domestic affiliate. More particularly, a dual consolidated loss of a dual-resident corporation cannot offset the taxable income of any domestic affiliate in a taxable year in which the losses are recognized or in any other taxable year, regardless of whether the loss offsets income of another person under the income tax laws of a foreign country and regardless of whether the income that the loss may offset in the foreign country is, has been, or will be subject to tax in the United States.[73]

A "dual-resident corporation" is a domestic corporation that is subject to the income tax of a foreign country on its worldwide income or on a residence basis. For the purpose of applying these rules, a "separate unit" of a domestic corporation is treated as a separate domestic corporation.[74] A hybrid entity, such as a ULC, is treated as a "separate unit" for these purposes.[75] Accordingly, a ULC is treated as a dual-resident corporation for the purposes of the DCL rules.[76] The common exception to the DCL rules is the making of an election by the consolidated group that the losses, expenses, or deductions of the ULC have not been (or will not be) used to offset the income of another person under foreign law (in this case, Canada).[77]

Indirect Foreign Tax Credit

A US C corporation can claim an indirect foreign tax credit for the underlying tax of a Canadian limited corporation so long as it owns 10 percent or more of its voting shares.[78] The indirect foreign tax credit for foreign tax paid by a Canadian limited corporation is unavailable to US shareholders who are individuals (including trusts or estates) holding those shares either directly or through a limited liability company, partnership, or S corporation. If the Canadian corporation

is a ULC, the shareholders will be eligible to claim a direct foreign tax credit for any tax paid by the ULC on its income, subject to complicated numerical limitations described in Code section 904.

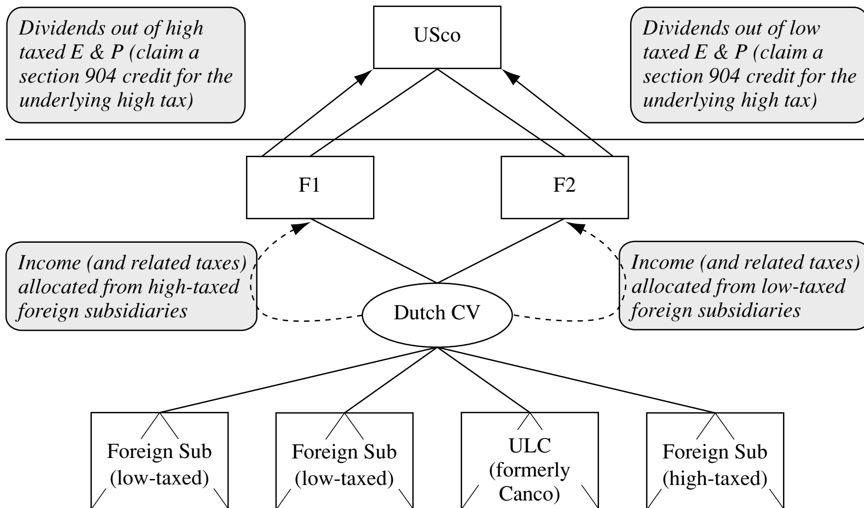
Foreign Tax Credit Planning

A ULC can be used to control a US corporation's foreign tax credit position. A US company can be either in an excess foreign tax credit position (that is, it has more foreign tax credits than US income tax, which could be utilized to offset that US income tax on repatriated income) or in an excess limitation position (that is, the foreign tax credits are exceeded by the corresponding US income tax that would arise on repatriated income).

A US multinational (USco) may wish to avoid having the foreign tax credit watered down by mixing low-taxed and high-taxed foreign-source income. For example, it could implement the following transactions (illustrated in figure 1) that involve the use of a ULC:

1) USco forms two foreign entities (F1 and F2) that are flowthrough entities in the foreign jurisdiction but eligible entities that USco has elected to treat as corporations for US tax purposes (therefore, they are controlled foreign corporations, or CFCs).
2) F1 and F2 form a Dutch CV, which is a partnership for Dutch income tax purposes.
3) USco contributes to F1 and F2 its foreign subsidiaries (including, in the case of F1, its Canadian operating company (Canco)) subject to high rates of tax and its foreign subsidiaries subject to low rates of tax. In the case of the contribution of Canco to F1, another Luxembourg (or Netherlands) entity could be interposed between F1 and Canco so that the holder could access the lower rate of withholding tax under the relevant income tax convention.
4) The low-taxed and high-taxed foreign subsidiaries are converted by F1 and F2 into "eligible entities" (for example, Canco is converted into a ULC) and check-the-box elections are made where necessary to treat those subsidiaries as disregarded entities.[79]
5) F1 and F2 contribute the foreign subsidiaries that are disregarded entities to the Dutch CV.
6) The terms of the partnership agreement governing the Dutch CV provides that 90 percent of the earnings from the high-taxed foreign subsidiaries, such as the ULC (including related high foreign taxes) and 10 percent of the earnings from the low-taxed foreign subsidiaries (including related low foreign taxes) are allocated to F1, and 90 percent of the earnings from the low-taxed foreign subsidiaries (including related low foreign taxes) and 10 percent of the earnings from the high-taxed foreign subsidiaries (including related high foreign taxes) are allocated to F2.[80]

Figure 1



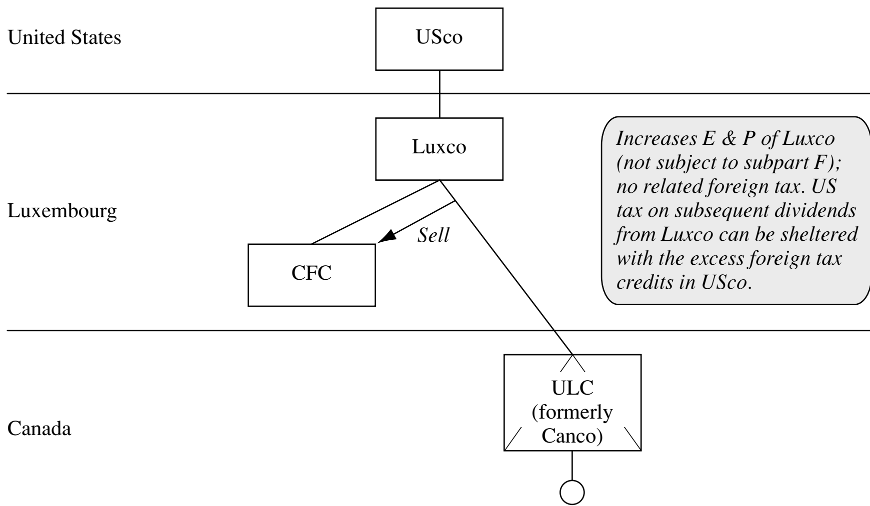
USco can then pick and choose between the high-taxed and low-taxed pools of earnings and profits (E & P) by controlling the timing of the dividend payments from F1 and F2. If USco is in an excess foreign tax credit position, dividends can be paid from F2; if USco is in an excess limitation position, dividends can be paid from F1.

USco can also structure a sale of Canco if it wishes to deal with its excess foreign tax credit position. (See figure 2.) USco would structure the following transactions, assuming that Canco is owned by a Luxembourg entity (Luxco) that is treated as a CFC for US tax purposes:

1) Canco is converted into a ULC so that it is treated as a disregarded entity. No Canadian income tax consequences are associated with the conversion.
2) Luxco sells the shares in the ULC to another CFC within the affiliated group for cash. The transfer of the shares is not subject to Canadian income tax by virtue of the Canada-Luxembourg income tax convention so long as the value of the shares is not derived primarily from real property situated in Canada that is not used in the business of the ULC.[81]

The conversion of Canco into a ULC will not give rise to any US income tax. The subsequent sale of the shares in the ULC to a CFC will not give rise to any Canadian income tax on the gain from the disposition of the shares and will be treated as a sale of the assets of the ULC to the CFC without any related foreign tax. The income from the sale of the assets from a US income tax perspective will not be treated as subpart F income so long as the assets of the ULC were used in

Figure 2



an active business.[82] When a dividend is subsequently paid to USco it will be able to use its excess foreign tax credits to shelter its US domestic tax paid on the low-taxed E & P repatriated from Luxco.

Conversion of a Stock Reorganization into a Transfer of Assets for US Income Tax Purposes

The transfer by USco of a CFC to another CFC for shares can be accomplished without any immediate tax on the gain so long as USco complies with the requirements of Code section 367(a). One of the requirements is that USco and the transferee CFC enter into a gain recognition agreement. In effect, the gain recognition agreement will require USco and the transferee CFC to agree that USco will not dispose of the shares in the transferred CFC (or substantially all of the assets of the transferred CFC) for a period of five years. If the shares (or substantially all of the underlying assets) are transferred during that period, USco must recognize the gain that existed at the time of the original transfer; the gain is treated as having been realized in the year of the original transfer.

Accordingly, USco will have to pay the income tax on the gain that was deferred, and it would have to pay interest on that tax liability calculated from the date of the original transfer. However, if Canco is converted into a ULC and a check-the-box election is made immediately before or after the transfer of the shares by USco to the CFC, the transaction will be treated as a "foreign-to-foreign" reorganization of Canco and the transferee CFC, rather than as an "outbound" transfer of the shares of Canco.[83] In that case, Code section 367(b) rather than section 367(a) applies, and there is no need for a gain recognition agreement.

Worthless Stock Deduction

A US taxpayer may claim a loss on its shares in a Canadian company (Canco) in the course of its dissolution.[84] The loss can be claimed on an actual liquidation or on a liquidation caused as a consequence of converting Canco into a ULC. In the context of a check-the-box election, the IRS has considered whether or not a check-the-box election could trigger a worthless stock deduction.[85]

In Revenue ruling 2003-125,[86] the IRS ruled that in the event of a deemed liquidation of a wholly owned subsidiary into its parent company that results from a check-the-box election, the non-recognition provisions of Code section 332 that would normally apply in such a case will not apply if the subsidiary is insolvent (that is, the fair market value of the subsidiary's assets, including goodwill, is less than its liabilities). If the non-recognition provisions of Code section 332 are not applicable, the parent company is entitled under Code section 165(g) to recognize any loss on its shares in the subsidiary.

The amount of the loss is the holder's cost in the shares that are treated as being disposed of in the course of the dissolution. The loss will be a capital loss (rather than an ordinary loss) unless the holder of the shares is a US domestic corporation, the foreign subsidiary is affiliated[87] with that corporation, and more than 90 percent of the subsidiary's gross receipts over the term of its existence is from qualifying (non-passive) sources.[88] A number of issues must be considered in the course of using the check-the-box election to claim a worthless stock deduction.[89]

Check-and-Sell Planning

A gain from the sale of shares in a Canadian company (Canco) held by another CFC of a US person gives rise to subpart F income.[90] However, if the underlying assets of Canco are used in an active business, the disposition of those assets will not give rise to subpart F income.[91]

Accordingly, in the event that a CFC is going to sell the shares in Canco, a wholly owned subsidiary, the conversion of Canco into a ULC, a disregarded entity, will be considered a tax-free liquidation of Canco into the CFC.[92] The subsequent sale of the shares in the ULC will be treated as a sale of the underlying assets for US tax purposes not giving rise to subpart F income or any immediate income recognition in USco, since the income is realized in the CFC. If there is a tax treaty between the CFC's country of residence and Canada, the gain on the sale of the shares of Canco is not subject to Canadian income tax so long as the value of the shares in Canco do not derive their value principally from real property situated in Canada (in some cases, the treaty relief is even broader).

The IRS is concerned about this type of planning. In non-precedential guidance, the IRS stated that the dissolution of a CFC through a check-the-box election and the subsequent sale of the shares in the former CFC (a disregarded

entity) would not be respected for technical reasons.[93] The next response was the introduction of proposed regulations that invalidated a check-the-box election if there was an "extraordinary transaction" involving a foreign corporation (in effect, an extraordinary transaction was the conversion of a foreign entity treated as a corporation for US income tax purposes into a disregarded entity, followed by a sale of the interest in the entity within a certain time). The extraordinary-transaction regulations were subsequently withdrawn after significant protests from the tax community.[94]

The IRS's technical arguments against check-and-sell planning were defeated in *Dover*.[95] In that case, the IRS argued that Code section 332 was not available to the CFC that held the shares in the foreign corporation converted into a disregarded entity. The basis for its argument was that the assets had not been used by the CFC (notwithstanding the check-the–box election) in its trade or business, and the corporation's trade or business could not be attributed to the CFC. The court concluded that a check-the-box election to cause a single-member entity to be a disregarded entity had the same effect as if the entity had actually been dissolved. Accordingly, since the IRS had previously ruled in Revenue ruling 75-223[96] that Code section 332 was applicable to an actual liquidation, the court held that the same treatment should be extended to a deemed liquidation.

A more recent US policy development relating to check-the-box planning in the international area is the recommendation of the Joint Committee on Taxation.[97] The committee observed that check-the-box planning has facilitated subpart F planning. For example, the committee noted that payments between foreign entities do not give rise to subpart F income if one of the entities is a disregarded entity. The committee also mentioned the planning in *Dover*.

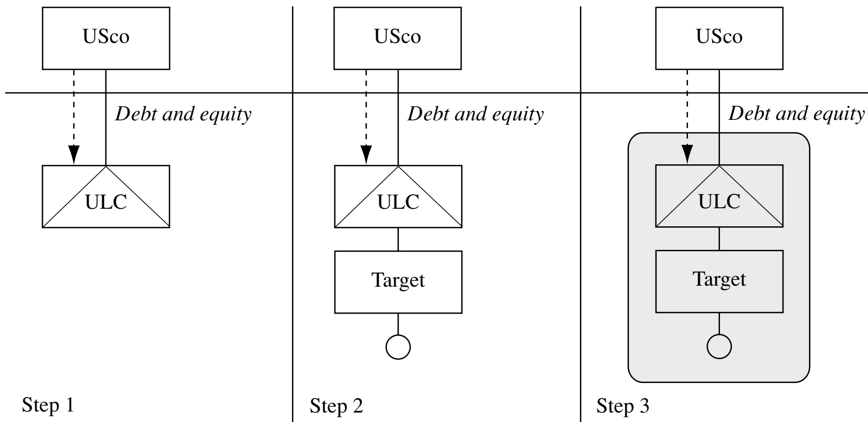
The committee is also concerned with hybrid branch structures, which permit a deduction in a foreign jurisdiction without an income inclusion in the United States under the subpart F rules. The committee's fear is that this type of planning distorts investment decisions by causing US persons to invest capital abroad. Although the committee did consider that this type of inconsistent treatment between the United States and other countries is to be expected in a world with different tax systems, it recommended that a single-member foreign eligible entity not be permitted to elect to be a disregarded entity for US tax purposes.

Financing Structure

The ULC can also be used in the course of financing a purchase of a Canadian company by a US person or injecting additional debt in a Canadian subsidiary. For example, USco can undertake the following transactions in the case of a share purchase (illustrated in figure 3):

1) USco incorporates a ULC to be the acquisition vehicle.
2) The ULC is capitalized with debt and equity by USco within the thin capitalization limitations.[98]

Figure 3



3) The ULC uses the borrowed funds and equity to acquire another Canadian corporation ("the target").
4) USco makes a section 338 election in connection with the acquisition of the target, and USco steps up the cost of all of the underlying assets of the target to their fair market value for US tax purposes. The section 338 election can result in the recognition of goodwill in the target, which can be amortized for US income tax purposes because the target is treated as a new corporation that has acquired all of the assets of the target immediately before the making of the election.[99]
5) The target and the ULC are amalgamated to form a ULC (Amalco).[100]

The effect of these transactions is that USco has a mechanism to extract its purchase price from Canada for Canadian tax purposes without incurring any Canadian income tax through either a repayment of the debt or a return of paid-up capital.[101] From a US tax perspective, USco has full basis in the underlying assets of the target and possibly will have created amortizable goodwill, and Amalco will be a branch of USco. The non-depreciable capital properties owned by the target (such as subsidiaries and land) will be eligible for the paragraph 88(1)(d) bump as a consequence of the target's amalgamation with the ULC.

Amalco will be able to deduct interest from its income on the debt owed to USco, and USco will have to pay 10 percent withholding tax on any interest paid or credited to it. The interest paid on the debt owed by Amalco to USco will not be recognized for US tax purposes because Amalco is a disregarded entity (therefore, USco is treated as both the borrower and the lender). However, the income attributable to USco from its branch operations in Canada for US tax purposes will be higher than it is for Canadian purposes, all other things being

equal, because the interest deduction will not be recognized in calculating its income from those operations. The deferral of this income is the benefit of the use of a "reverse hybrid" structure, which is discussed below.

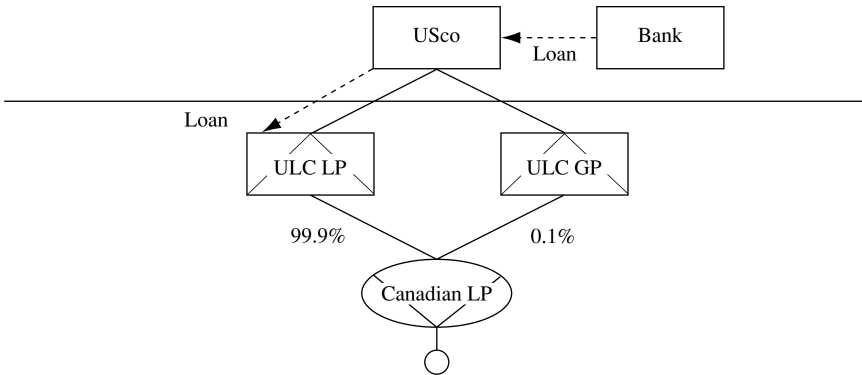
In order to obtain a deferral, a reverse hybrid (that is, a partnership treated as a flowthrough for Canadian income tax purposes and a corporation for US income tax purposes) can be used together with a ULC, in which case the deferral will generally last until the reverse hybrid makes actual distributions. Consider the following structure in the context of an asset purchase (illustrated in figure 4):

1) USco incorporates two ULCs (a C corporation could be inserted between USco and the ULCs to deal with the unlimited liability issue), which are disregarded for US tax purposes.
2) The two ULCs form a Canadian limited partnership (Canadian LP), and USco checks the box to treat Canadian LP as a corporation for US tax purposes. USco selects one of the ULCs to be the limited partner (ULC LP) and the other to be the general partner (ULC GP). ULC LP and ULC GP are entitled to 99.9 percent and 0.1 percent, respectively, of the profits and losses of Canadian LP.
3) USco borrows funds from a US bank. USco capitalizes ULC LP with debt and equity within the thin capitalization limitations. ULC LP invests the money in Canadian LP in exchange for additional equity in Canadian LP.
4) Canadian LP purchases the assets from the Canadian vendor using the money received from ULC LP.

For Canadian tax purposes, ULC GP will include in its income (or claim a loss) equal to 0.1 percent of the profits (or losses) of Canadian LP. ULC LP will include in its income (or claim a loss) equal to 99.9 percent of the income of Canadian LP. ULC LP gets an interest deduction for the interest payable on the loan to USco. USco pays 10 percent Canadian withholding tax on any interest paid or credited to it from ULC LP.

USco does not recognize the interest income on the loan to ULC LP because ULC LP is a disregarded entity. Canadian LP is treated as a CFC for US tax purposes. USco claims a direct foreign tax credit for the Canadian withholding tax paid on the interest from ULC LP and the Canadian income tax paid by both ULC GP and ULC LP in respect of their share of the income allocated from Canadian LP. USco is able to claim a direct foreign tax credit because ULC LP and ULC GP are liable for the Canadian income tax,[102] and such liability is attributed to USco because the ULCs are disregarded. Even though USco gets to claim a direct foreign tax credit for the Canadian income tax of ULC GP and ULC LP, USco does not have to include the income allocated to them for Canadian income tax purposes because Canadian LP is a corporation for US tax purposes.[103] Any distribution by Canadian LP to ULC LP or ULC GP is treated for US tax purposes as a payment of dividends by Canadian LP to USco to the extent of the E & P in Canadian LP.

Figure 4



The Canadian vendor may be unwilling to sell assets and may wish to sell the shares of a Canadian company (Canco). The reverse hybrid structure described above can still be used, subject to certain changes. In addition to the steps outlined above, Canadian LP will incorporate another ULC, which is capitalized with debt and equity. The debt is disregarded because the ULC is a disregarded entity. The ULC purchases the shares of Canco, makes a Code section 338 election, and then amalgamates with Canco after closing to form a ULC (Amalco). USco does not have the same foreign tax credit advantage associated with purchasing assets. USco will not be able to recognize an immediate direct foreign tax credit for the Canadian income tax on Amalco's income after the amalgamation because ULC LP and ULC GP are not liable for the Canadian income tax payable on that income.

Another alternative, which ends up with the same structure as an asset acquisition using the reverse hybrid described above, is to have USco form a ULC and capitalize it with debt and equity for the purposes of the acquisition of Canco. The ULC then purchases the shares of Canco, makes a Code section 338 election, and amalgamates with Canco after closing to form a ULC (Amalco). Amalco incorporates another ULC, and each of them forms a limited partnership that checks the box to be treated as a corporation. Amalco then transfers its assets to the limited partnership for a partnership interest. In effect, the structure is the same as that shown in figure 4, with USco being able to claim a direct foreign tax credit for all of the Canadian income tax payable on Canco's income that is

now earned through a limited partnership, in contrast to the scenario described in the immediately preceding paragraph.

Tower Structures

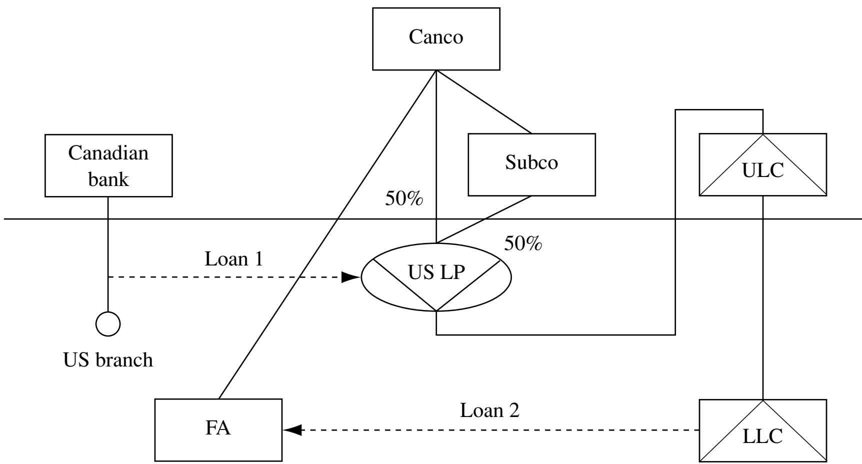
ULCs are also used in tower structures. A tower structure is used by Canadian companies to acquire or finance operations in the United States. Assume, for example, that Canco owns a foreign affiliate (FA) in the United States that has to refinance its existing US credit facility. Canco decides that the facility should be replaced with a Canadian facility and implements the following transactions (illustrated in figure 5):

1) Canco incorporates another Canadian subsidiary (Subco). Canco and Subco each form a US limited partnership (US LP); each of them contributes $500,000 to US LP for a 50 percent interest.
2) Canco and Subco check the box to treat US LP as a C corporation for US tax purposes.
3) US LP incorporates a ULC, which is a disregarded entity for US tax purposes.
4) The ULC forms an LLC, which is a disregarded entity for US tax purposes.
5) US LP borrows money ("loan 1") from the US branch of a Canadian bank or the Canadian branch of a US bank.
6) US LP uses the borrowed funds to subscribe for additional shares in the ULC.
7) The ULC uses the borrowed funds to subscribe for additional membership interests in the LLC.
8) LLC on-lends the funds ("loan 2") to FA on terms substantially the same as those of loan 1.
9) FA repays its US credit facility.

From a US tax perspective, the payment of any interest on loan 2 will be treated as a payment of interest by FA to US LP, which is a "domestic corporation" for US tax purposes because it was formed under state law. The interest is treated as paid by FA directly to US LP because the LLC and the ULC are disregarded entities. For US tax purposes, the payment of interest by US LP on loan 1 will be deductible by US LP for the purpose of calculating its income on the income that it earns on loan 2. No US withholding tax will be payable on loan 1 if it is owed to the Canadian bank so long as loan 1 is effectively connected with a US permanent establishment of the bank.[104] If the interest on loan 1 is payable to a US bank, no Canadian withholding tax should be payable if loan 1 is effectively connected with a Canadian branch of the bank or, alternatively, the interest is not treated as being paid by one of the partners.[105] For US tax purposes, FA will be able to deduct the interest on loan 2 from its income.

From a Canadian tax perspective, the interest on loan 2 is treated as income from an active business and not foreign accrual property income so long as FA is carrying on an active business.[106] The payment of the interest received by the

Figure 5



LLC to the ULC as a dividend will be treated as a payment out of the LLC's exempt surplus so that the ULC will be able to claim a corresponding deduction for that amount from its income for Canadian income tax purposes.[107] The payment of the dividend from the ULC to US LP will be considered to be income of the US LP, which is a Canadian partnership for Canadian income tax purposes,[108] and US LP will be able to deduct the interest that it pays on loan 1 to the bank in calculating its income for Canadian income tax purposes. The amount of the income in the partnership is nominal, since the dividend payments approximate (after tax) the interest payable on loan 1. The income from US LP is then allocated between the two Canadian partners. Each of the Canadian partners will be able to claim a deduction from its income for the amount of the dividend paid by the ULC to US LP, resulting in a loss for each of the partners which they can then deduct from their other sources of income.[109] No Canadian withholding tax is payable on the dividend paid by the ULC to US LP because it is treated as a Canadian partnership for the purposes of Canadian withholding tax.

The purpose of using a ULC between US LP and the LLC is to deal with the uncertainty that would otherwise result if US LP owned the membership interests in the LLC directly. In such a case, for the purposes of having the interest recharacterized as income from an active business, the LLC must be a "foreign affiliate" of the corporate partners, and they must have a "qualifying interest" in the LLC.

The issue is whether or not the fiction created by section 93.1 of the ITA, which treats a corporate partner for certain purposes as owning the shares of a corporation that are owned (or deemed to be owned) by a partnership, extends to the recharacterization rule. The fiction created by section 93.1 is relevant only for certain purposes of the ITA; arguably, it is not relevant for the purposes of

applying subparagraph 95(2)(a)(ii).[110] The ULC avoids the problem, since it has a qualifying interest in the LLC and the LLC is a foreign affiliate of the ULC.

US Beneficiary of a Canadian Trust

If a Canadian trust has a non-resident beneficiary, the trust is subject to part XII.2 tax on its "designated income."[111] If a US person is to be a beneficiary of the trust, part XII.2 tax can be avoided if the US person holds its interest in the trust through a ULC.

Canadian Partnership

The residence of a partnership is determined differently for Canadian tax purposes than it is for US tax purposes. The ITA does not classify a partnership for Canadian income tax purposes on the basis of where it is formed, but, in certain cases, on the basis of the residence of its members. For US tax purposes, the residence of a partnership is determined by whether or not the partnership is formed under US law or foreign law. Accordingly, a partnership can be a domestic partnership for US tax purposes if formed under US state law, and a "Canadian partnership" for Canadian tax purposes so long as its members are residents of Canada.

A partnership is treated as a non-resident for the purposes of Canadian withholding tax if at least one of its members is not a resident of Canada. As well, certain rollovers involving a partnership are not available unless all of the members of the partnership are residents of Canada. If the status of the partnership as a "Canadian partnership" is relevant for Canadian income tax purposes (for example, the partnership may be receiving passive income, which will be subject to Canadian withholding tax if it is not a Canadian partnership), a US person can participate in the partnership without tainting its status and can be treated as a member of the partnership for US tax purposes if it holds its interest in the partnership through a ULC.

Services Performed by Non-Residents in Canada

A non-resident who performs services in Canada either directly, through its own employees, or indirectly, through Canadian subcontractors, is subject to certain withholding obligations.[112] More particularly, a payer is obligated to withhold 15 percent from any payment of a fee, commission, or other amount to a non-resident person in respect of services rendered in Canada.

If a US resident has a contract in Canada and does not wish to seek section 105 relief, it can divide its contract between Canadian services and US services and incorporate a ULC to perform those services that have to be physically performed in Canada. The payment of those amounts by the payer to the ULC will not be considered subject to the section 105 withholding requirements, because the payment is made to a Canadian resident, not to its US shareholder.[113]

Leased Equipment

A US person may use substantial machinery in the course of its business. If there is no restriction on the geographic use of the equipment, the US person is free to use the equipment in its business either in the United States or in Canada. If the US person obtains a contract in Canada to perform services in Canada, not only will the non-resident have to deal with the section 105 issues discussed above, but it will also, from a Canadian income tax perspective, be treated as a Canadian resident with respect to the use of the equipment in Canada. Accordingly, the US person will be obligated to withhold the applicable rate of Canadian withholding tax on any lease payments to its US lessor.[114]

The commercial consequences of subjecting the US lessor to Canadian withholding tax can be avoided by having the US person sublease the equipment to a ULC formed by the US person. The ULC will then use that equipment and the applicable employees (subject to the 105 withholding considerations described above) to perform its obligations under the Canadian contract. The withholding obligation will then be imposed on any lease payments made by the ULC to its US shareholder.[115]

Synthetic Section 338 Election

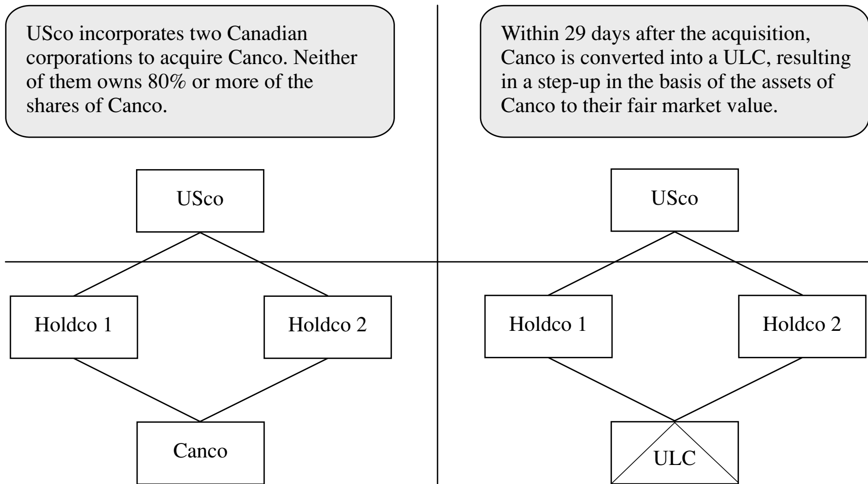
There may be circumstances in which a Code section 338 election cannot be made by a US purchaser that wants to purchase the shares of a Canadian company (Canco). For example, the purchaser may not be a corporation, or there may be negative tax consequences to the vendor. The US purchaser can implement a synthetic section 338 election after the purchase by undertaking the following transactions (see figure 6):

1) USco incorporates two Canadian limited corporations (Holdco 1 and Holdco 2).
2) Holdco 1 and Holdco 2 each acquire 50 percent of the shares of Canco from the vendor.[116]
3) Within 29 days of the acquisition of Canco, Canco is converted into a ULC, and a check-the-box election is made to treat it as a partnership for US tax purposes.

Canco is treated as having been liquidated for US tax purposes and its assets contributed to a partnership (in this case, a foreign partnership).[117] Accordingly, there is a disposition of the shares in Canco by Holdco 1 and Holdco 2, which are CFCs, pursuant to Code section 331, and a disposition by Canco of its assets for fair market value pursuant to Code section 336. There should be little gain on the disposition of the shares in the course of the liquidation because Holdco 1 and Holdco 2 should have full basis in the shares.

The gain on any passive assets of Canco will be subpart F income; however, there will not be any income inclusion to Holdco 1 or Holdco 2 because the

Figure 6



shares will have been held for less than 30 days.[118] The income received by Canco between its acquisition and conversion presumably increases the value of the Canco shares and will thus cause Holdco 1 and Holdco 2 to recognize some gain on the conversion, but no portion of this gain will be recognized as a dividend under Code section 1248.[119]

The liquidation of Canco will eliminate the associated E & P. There will be a step-up in the basis of the assets of Canco to their fair market value as a consequence of the dissolution: the rollover under section 332 is not applicable, because neither Holdco 1 nor Holdco 2 owns 80 percent or more of the shares in Canco. Advance planning must be undertaken in connection with the implementation of this type of transaction, since it must be completed within 30 days after the acquisition of Canco if subpart F is to be avoided.

An alternative synthetic section 338 transaction involves the following transactions:

- The vendor converts Canco into a ULC before sale. Part of the planning involves the vendor interposing an intermediary between Canco and itself to avoid any unlimited liability as a member or shareholder of the ULC.
- The vendor causes its intermediary to sell the shares of the ULC to USco.

The vendor can accomplish the pre-closing transactions and subsequent sale without incurring any more Canadian income tax than it would otherwise incur if it sold Canco directly, unless the vendor is an individual who wants to sell the shares personally.[120] The subsequent sale of the shares in the ULC by the vendor to USco will be treated as a sale of the ULC's underlying assets by the vendor. USco will obtain full basis in those assets and no E & P. The ULC will be treated

as a branch of USco after the acquisition. An NSULC rather than an AULC is the preferred ULC, because the risk of unlimited liability incurred by the vendor is less than it would be if the ULC was an AULC.

Like-Kind Exchange with a Bankruptcy Remote Entity

A ULC can also be used for like-kind exchange planning.[121] There may be circumstances in which the exchange of one property for another property requires bank financing when the proceeds from the sale of the first property are insufficient to finance the acquisition of the replacement property. The lender may not be comfortable with the owner acquiring the property directly because, even though the lender may have security, the replacement property will be subject to the other liabilities of the owner. Accordingly, the lender may demand that the US person create a bankruptcy remote entity to acquire the property.

The like-kind exchange rules will not defer the US tax liability unless the owner of the original property acquires the replacement property directly. The acquisition of the property by a disregarded entity may satisfy the lender's concerns and still permit a rollover for the borrower.[122]

In the Canadian context, the US owner can use a ULC as the holder of the property that will replace a Canadian property. The US owner will incorporate a ULC and own all of the voting common shares. One share of a second class of shares in the ULC without any entitlement to dividends, liquidation proceeds, or votes (except in limited circumstances) will be issued to a Canadian limited company (or a foreign entity, such as an LLC). The lender will hold a share in this other company. All decisions of the ULC will be made solely by the US owner. However, so long as the loan is outstanding from the lender to the ULC, without the approval of the second company (with the approval of all of its directors) the ULC may not

- file or consent to the filing of a bankruptcy or an insolvency petition or otherwise institute insolvency proceedings;
- dissolve, liquidate, merge, consolidate, or dispose of all or substantially all of its assets;
- engage in any business activities other than those specified in its constating documents;
- borrow money or incur indebtedness other than normal trade accounts payable or any other indebtedness, unless expressly permitted by the lending documents;
- take or permit any action that would violate any provision of the lending documents; or
- amend any provision of the constating documents dealing with the items referred to above.

In addition, the written consent of the lender will be necessary if the ULC attempts any of those actions. In the situation outlined, the ULC should be

treated as a single-member entity, and therefore all of the assets and liabilities of the ULC should be treated as the assets and liabilities of the US owner for the purposes of the like-kind exchange provisions. The corporate owner should be ignored, since it has no right to participate in the management of the ULC and it has no right to profits or income associated with its participation in the ULC.

Moving Cash Among Foreign Corporations Under a CFC

Interest, dividends, royalties, etc. (subject to certain exceptions, such as the same-country exception) are treated as subpart F income for US tax purposes when paid between CFCs. A payment by a foreign entity to a CFC will not be subject to subpart F income treatment if that entity is a disregarded entity. Accordingly, dividends, interest, royalties, and other passive amounts paid to a CFC by a ULC that is a disregarded entity will not give rise to subpart F income.

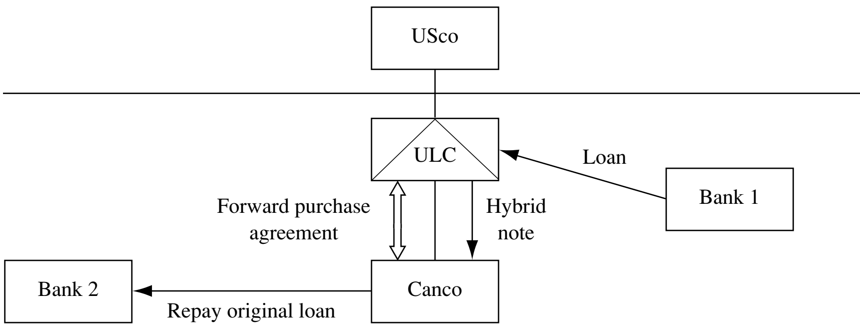
A popular US holding company structure involves, for example, a ULC that is wholly owned by a Luxembourg entity (Luxco). Luxembourg has treaties with Canada and the United States. Any dividends paid by the ULC to Luxco will result in Canadian withholding tax at the rate of 5 percent and will be ignored for US tax purposes. Luxco will have no income inclusion in Luxembourg because of the participation exemption. Any interest paid by ULC to Luxco is subject to Canadian withholding tax of 10 percent, and any gain on the disposition of its shares is not subject to Canadian income tax so long as the shares do not derive their value from immovable property situated in Canada that is not used in its business.[123] Luxembourg imposes a withholding tax of 5 percent on dividends paid to a US company under the US-Luxembourg tax convention. The withholding tax and the Luxembourg capital tax can be avoided by using PECs (preferred equity certificates), which are treated as equity for US purposes but as debt for Luxembourg purposes. Luxembourg imposes no withholding tax on interest paid to non-residents.

Hybrid Debt Instrument

A US person can also use hybrid debt to finance Canadian operations.[124] A ULC may be used in this type of structure. A hybrid debt structure can take on many forms. The following structure (illustrated in figure 7) may be used by USco to finance an acquisition or in the course of a new financing of its Canadian operations carried on through a Canadian company (Canco):

1) USco incorporates a ULC.
2) USco transfers the shares of Canco to the ULC.
3) The ULC borrows money from a Canadian bank or a US bank with a Canadian branch (or from a bank within the United States if the borrowed funds satisfy the domestic exemption from Canadian withholding tax)[125]

Figure 7



on a term basis; repayment is due on a specified date in the future ("the maturity date").

4) The ULC on-lends the proceeds from the loan on an unsecured basis to Canco for a slight spread in interest rates ("the hybrid note"). The hybrid note requires that the principal amount be paid in full on the maturity date in an amount equal to the amount of the loan. The terms of the hybrid note also provide that interest will be paid in common shares.[126]
5) Canco retires its debt to its existing bank using the proceeds from the hybrid note.
6) The ULC and Canco enter into a forward purchase agreement whereby
   a) the ULC agrees to purchase a certain number of common shares in Canco on the same date as the maturity date for an amount equal to the amount due under the hybrid note or on an earlier date if the hybrid note is repaid. The fair market value of the common shares on the date of their issue is determined to be equal to the amount of the hybrid note.
   b) Canco agrees to accept as payment of the subscription price for the common shares on the same date as the maturity date for the hybrid note (or on an earlier date if the hybrid note is prepaid) the delivery of the hybrid note if Canco does not repay the hybrid note on the maturity date; and
   c) Canco can repay the hybrid note by the issuance of the common shares on the maturity date if the ULC does not subscribe for the common shares in cash on that date.
7) USco subscribes for additional common shares from time to time in the ULC so that the ULC will have sufficient funds to pay interest on the loan.
8) On the maturity date, Canco borrows money on a daylight basis and uses those funds to repay the hybrid note. The ULC subscribes for the common shares in Canco by paying to it an amount equal to the amount received under the hybrid note. Canco repays the daylight loan. USco subscribes for

additional common shares in the ULC in an amount equal to the amount of the loan, and the ULC repays the loan with the amount received from USco.

From a US perspective, it is important to ensure that the hybrid note and the forward purchase agreement are not considered severable. Accordingly, the basic structure should, among other things, contain a number of other features that make it difficult to sever those instruments, such as

- a prohibition on the assignment of the hybrid note unless the assignee also assumes the responsibility of the assignor under the forward purchase agreement;
- a prohibition on the assignment of the forward purchase agreement without an assumption of the assignor's liability under the hybrid note; and
- a pledge by Canco of its rights under the forward purchase agreement as security for the hybrid note.

From a Canadian income tax perspective, each of the ULC and Canco should be entitled to a deduction for the interest. A possible Canadian issue is potential debt forgiveness if the interest or principal payments are settled in shares and they have a fair market value that is less than the interest or principal due at the time of their issue. From a US perspective, the ULC is disregarded, and USco is treated as owning the shares in Canco and as owing the loan to the bank. USco gets an interest deduction for the interest payments that it funds when it subscribes for shares in the ULC that is then used by the ULC to make payments to the bank. From a US tax perspective, the payment of interest and principal by Canco to the ULC and the subscription for common shares in Canco will be treated as a stock dividend of common shares and will not be subject to US income tax. If the note is severable from the forward purchase agreement, the hybrid note may be treated as debt from a US tax perspective, in which case USco must accrue the income on the hybrid note.

In summary, the effect of a hybrid debt structure utilizing the ULC is to permit USco to obtain a deduction for US tax purposes and Canco to obtain a deduction for Canadian purposes, with no income inclusion on payments under the hybrid note or the recognition of any of the income of Canco in USco since Canco is a CFC for US tax purposes. There are many issues with the use of this structure. For example, there is a certain amount of tension between Canadian and US tax law as it relates to the integration of the instruments. That is, from a US tax perspective a US adviser desires to have the transactions linked together as closely as possible, whereas from a Canadian perspective there is a concern about linking those instruments together too tightly.[127]

One consideration in using this type of structure is its impact on the future foreign tax credit that can be claimed by USco, since the effect of the structure is to create low-taxed E & P in Canco (that is, the E & P of Canco will be higher because the interest expense is not recognized in calculating Canco's E & P, and the Canadian tax will be lower because of the effect of the interest deduction).

Subpart F Planning

A ULC can also be used to minimize subpart F income inclusion in a US corporation (USco). USco, for example, may have a number of foreign subsidiaries (including a Canadian corporation (Canco)) that generate losses under a Luxembourg entity (Luxco). If Canco is converted into a ULC, the calculation of subpart F income in Luxco can be reduced, since the ULC's losses will reduce the E & P in Luxco.[128]

In this type of planning, other factors must be taken into account. For example, converting Canco into a ULC may eliminate the benefit of multiplying the de minimis $1 million exemption from the subpart F income inclusion.[129] Another risk is that all the income of Luxco could become subject to subpart F if 70 percent or more of its income is characterized as subpart F income, which could occur if subpart F income from a number of entities is aggregated into one entity.[130]

Conclusion

Neither an NSULC nor an AULC is better from a US tax perspective. However, the restraints (or flexibility) imposed (or conferred) by one corporate jurisdiction on the other may have an impact on which ULC will be used for a particular transaction. At present, the AULC, from a cost perspective, is far cheaper to use ($100) than the NSULC ($6,000). Although the difference in cost may not be material for many transactions, the cost has proved to be an aggravation. It is hoped that the Nova Scotia government will respond to this issue now that taxpayers have an alternative vehicle.

The AULC and the NSULC each have corporate advantages and disadvantages. The principal advantages of the NSULC are that the members' liability is restricted and can end (through a section 68 re-registration or by ceasing to be a member (subject to the one-year lookback rule)), and no Canadian residence requirements are imposed on directors. Nevertheless, there are concerns about the use of the NSULC (for example, the complicated process of converting a corporation into an NSULC, and financial assistance). The proposals recommend a number of amendments to the NSCA that deal with some of these corporate law issues. However, other corporate law issues (such as capitalizing contributed surplus) still need to be addressed.

In conclusion, the NSULC (surf) and the AULC (turf) can co-exist side by side. Which of the ULCs will be chosen for a particular transaction depends on the type of transaction and how the corporate law governing the particular ULC facilitates the implementation of the client's objectives.

Notes

1 A Nova Scotia unlimited liability company and an Alberta unlimited liability corporation are hereinafter referred to as an "NSULC" and an "AULC," respectively, and a reference to "ULC" is a reference to either one of them. A detailed description of the company law of the

NSULC can be found in Paul W. Festeryga, “Nova Scotia Unlimited Liability Companies: What Are They and How Do They Work?” in *Report of Proceedings of the Fiftieth Tax Conference*, 1998 Conference Report (Toronto: Canadian Tax Foundation, 1999), 17:1-28.

2 RSNS 1989, c. 81, as amended (herein referred to as “NSCA”). Statutes and jurisdictions that follow the Business Corporations Act model are identified with the abbreviation “BCA.”

3 Supra note 1.

4 An Act for the Incorporation and Winding Up of Joint Stock Companies, SNS 1862, c. 2 (herein referred to as “JSCA (1862)”).

5 F.W. Wegenast, *The Law of Canadian Companies* (Toronto: Burroughs and Company [Eastern] Limited, 1931), 24.

6 An Act Respecting the Incorporation of Joint Stock Companies by Letters Patent, SNS 1883, c. 24 (herein referred to as “NSJCA (1883)”).

7 See Wegenast, supra note 5, at 24.

8 SNS 1900, c. 128 (herein referred to as “NSCA (1900)”).

9 25 & 26 Vict., c. 89.

10 See Wegenast, supra note 5, at 24.

11 An Act To Amend the Nova Scotia Companies Act, 1900, SNS 1902, c. 8, section 9.

12 The NSCA (1900) was subsequently repealed and replaced several times, most recently by the Nova Scotia Companies Act, 1935, SNS 1935, c. 6.

13 See L.C.B. Gower, *The Principles of Modern Company Law*, 2d ed. (London: Stevens, 1957), 8.

14 NSCA section 57(1).

15 *In re Borough Commercial and Building Society*, [1893] 2 Ch. 242 (Ch. D.).

16 *Trevor v. Whitworth* (1887), 12 App. Cas. 409 (HL) imposed this restriction on the return of paid-up capital by a company limited by shares.

17 Supra note 15.

18 NSCA section 135.

19 RSA 2000, c. B-9, as amended (herein referred to as “ABCA”).

20 The increase in the stated capital of the company or corporation before the continuance can give rise to a deemed dividend pursuant to subsection 84(1) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (ITA), unless the exception described in paragraph 84(1)(c.3) is applicable. Experience shows that many US shareholders who contribute capital to a wholly owned Canadian corporation do not go through the formal step of issuing shares. Accordingly, the amounts contributed increase the cost of the shares and create contributed surplus in the Canadian corporation. In most BCA jurisdictions it is a relatively simple process to move, by resolution, the amount from contributed surplus to stated capital. Unfortunately, there is no express authority in the NSCA to capitalize the contributed surplus into paid-up capital. In such a case, a Nova Scotia arrangement would have to be undertaken to increase the contributed surplus—a more complex process than a resolution passed prior to the continuance.

21 Licences may not, by their terms, flow through as an asset of the amalgamated company. Also, agreements containing negative covenants are more likely to be triggered if there is an amalgamation rather than an arrangement.

22 See Don Sommerfeldt, “Alberta Unlimited Liability Corporations: A Corporate and Tax Overview,” elsewhere in this volume.

23 NSCA section 10.

24 NSCA section 20(3).

25 ABCA section 105(3).

26 NSCA sections 10 and 12.

27 ABCA section 26(1).

28 NSCA section 26(17).

29 ABCA section 28(3).

30 ABCA section 32.

31 ABCA section 101.

32 ABCA section 43.

33 ABCA section 27.

34 ABCA section 109.

35 ABCA section 27.

36 NSCA section 87.

37 ABCA section 1(ii).

38 ABCA sections 145 and 146.

39 ABCA section 183(5).

40 ABCA section 184.

41 ABCA section 45.

42 NSCA section 110(5).

43 ABCA section 122.

44 ABCA sections 118 and 119.

45 NSCA sections 23 and 55.

46 NSCA section 137.

47 ABCA section 210.

48 ABCA section 38.

49 NSCA section 57.

50 See supra note 15.

51 The registrar will not currently permit an NSULC or a Nova Scotia limited company to continue into Alberta directly as an AULC because under NSCA section 133(5), the registrar must be satisfied that the shareholders cannot be prejudiced as a consequence of this continuance. The change in the nature of the liability of the shareholders if the NSULC is continued into Alberta as an AULC is considered to be an event that would prejudice the shareholders.

52 Cox Hansen O'Reilly Matheson, *Proposals for Amendments to the Nova Scotia Companies Act: A Discussion Paper* (Halifax: Service Nova Scotia and Municipal Relations, 2005) (online: http://www.gov.ns.ca/snsmr/rjsc/pdf/discussion_paper.pdf) (herein referred to as "the proposals").

53 CRA document no. 2003-0051301E5, August 3, 2004; CRA document no. 2003-0004415, October 23, 2003; CRA document no. 2003-0018027, July 22, 2003; CRA document no. 2003-0057765, April 28, 2003; CRA document no. 2003-0007347, April 28, 2003; CRA document no. 2002-0143957, September 9, 2002; CRA document no. 2002-0120085, May 16, 2002; CRA document no. 9829875, February 10, 1999; CRA document no. 9642195, September 24, 1997; CRA document no. 9623967, June 23, 1997; CRA document no. 9610765, February 5, 1997; CRA document no. 9625015, January 28, 1997; CRA document no. 9624595, July 30, 1996; CRA document no. 9503045, August 30, 1995; CRA document no. 9415705, January 25, 1995; CRA document no. 9337725, June 29, 1994; CRA document no. 9410410, April 21, 1994; CRA document no. 9305495, June 30, 1993; *TaxPartner* (Toronto: Carswell) (CD-ROM database), document no. 5-6134, September 15, 1988, document no. A-9637, April 16, 1988, document no. rrrr75, May 11, 1983, CRA document no. rrrr76, May 1983, document

no. 12-2161, March 17, 1983, and document no. rrrr59, March 23, 1982; *Interpretation Bulletin* IT-343R, "Meaning of the Term Corporation," September 26, 1977; Angelo Nikolakakis, *Taxation of Foreign Affiliates* (Toronto: Carswell) (looseleaf), section 2.2.1; Vern Krishna, *The Fundamentals of Canadian Income Tax*, 6th ed. (Toronto: Carswell, 2000), 1126-28; and David G. Roberts, "Business Organization: Corporation, Partnership, or Other?" in the 1998 Conference Report, supra note 1, 48:1-29.

54 See, for example, CRA document no. 2001-0108715, August 13, 2002; CRA document no. 2000-0025855, September 25, 2000; CRA document no. 2000-0056715, November 28, 2000; CRA document no. 2000-0057765, November 28, 2000; CRA document no. 2000-0062015, December 21, 2000; *Interpretation Bulletin* IT-90, "What Is a Partnership?" February 9, 1973; *Income Tax Technical News* no. 20, June 14, 2001; Tanvi Vithlani, "The Application of Treaty Benefits to Partnerships: Characterization of a Foreign Entity," Corporate Tax Planning feature (2004) vol. 52, no. 1 *Canadian Tax Journal* 294-314; Yvette Morelli, "Structuring Venture Capital Funds" (2003) vol. 51, no. 2 *Canadian Tax Journal* 806-62; Ash Gupta, "Characterization of Foreign Entities" (2003) vol. 9, no. 2 *Business Vehicles* 438-47; and Allan R. Lanthier and Kerry L. Plutte, "International Hybrids: Pitfalls and Practice," in *Report of Proceedings of the Fifty-First Tax Conference*, 1999 Conference Report (Toronto: Canadian Tax Foundation, 2000), 46:1-38.

55 Internal Revenue Code of 1986, as amended (herein referred to as "the Code").

56 *Morrissey v. Commissioner, 296 US 344 (1935)*. The decision in *Morrissey* is the basis for the pre-1997 check-the-box regulations, which were promulgated in response to the decision in *United States v. Kintner*, 216 F. 2d 418 (9th Cir. 1954).

57 Internal Revenue Service Private Letter Ruling (PLR) 9538020, June 22, 1995.

58 The definition of "limited liability" for the purposes of applying the Kintner rules in former Treas. reg. section 301.7701-2(d)(1) read as follows: "An organization has the corporate characteristics of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization. Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim." An earlier ruling, Rev. rul. 88-8, 1988-1 CB 403, applied this rule to a UK ULC and concluded that "[a]s permitted under the Act, the Memorandum provides that the members' liability to contribute to the payment of *M*'s debts and liabilities is unlimited. Consequently, *M* lacks the corporate characteristic of limited liability."

59 A possible explanation may be the description of the attribute of limited liability for a corporation in former Treas. reg. section 301.7701-2(a)(1). The attribute is not described in that prior regulation as limited liability but as "the corporate debts being limited to corporate property." Arguably, an NSULC does not have that attribute because its corporate debts can be collected from the members by the liquidator of the NSULC.

60 Under the Kintner rules, an NSULC could not be characterized as a disregarded entity, only as a partnership or a corporation.

61 Treas. reg. section 301.7701-2(b)(8).

62 Treas. reg. section 301.7701-2(b)(8)(ii)(A)(1).

63 TD 8844, 1999-2 CB 661.

64 For the purpose of determining the number of members, US tax rules would be applied. Accordingly, if a ULC had two members from a Canadian legal perspective, the ULC could still be treated as having one member if each of those members was disregarded for US tax purposes and those members are held by one person.

65 Treas. reg. section 301.7701-2(a).

66 Treas. reg. section 301.7701-3(f)(2).

67 1999-1 CB 434. In the example, the LLC had no outstanding liabilities.

68 See Todd Voss, "*Disregarded Entities and Springing Boot" (2005) vol.* 83, no. 8 *Taxes: The Tax Magazine* 29-40. The article analyzed Rev. rul. 80-228, 1980-2 CB 115, which dealt with the transfer by a corporation of assets of a division together with a "notional payable" to a corporation. The IRS held that a gain had to be realized, since the rollover under section 351(a) was not available because the transferor received "other property" (that is, an account receivable arose as a consequence of the contribution of the division to, and the assumption of the liabilities of the division by, the transferee corporation).

69 Treas. reg. sections 1.707-4 and 5.

70 A limited exception is in the case of US companies that own shares in a Canadian company where under the laws of Canada the business can only be carried on through a Canadian corporation.

71 For example, for state tax purposes, a US corporation may not be entitled to consolidate a liability blocker that is a wholly owned domestic subsidiary. Accordingly, for state tax purposes, the US corporation would not be able to access the losses of the ULC that flow through to the domestic subsidiary. As outlined above, the liability associated with being a shareholder of an AULC is direct and cannot be capped or eliminated as it can for an NSULC through NSCA section 68. Furthermore, the liability of a past member of an NSULC lasts only for one year after it ceases to be a member, whereas for a shareholder of an AULC the liability does not, at the very least, end until the liability is satisfied.

72 Code section 1503(d).

73 Treas. reg. section 1.1503-2(b)(1).

74 Treas. reg. section 1.1503-2(c)(1).

75 Treas. reg. section 1.1503-2(c)(4) provides that a "separate unit" is defined as including an interest in an entity that is not taxable as an association for US income tax purposes but is subject to income tax in a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis.

76 Treas. reg. section 1.1503-2(c)(2).

77 Temp. Treas. reg. section 1.503-2T(g).

78 The foreign tax credit is claimed when a dividend is paid by the foreign corporation, in which case the domestic corporation claims a direct foreign tax credit for any withholding tax levied on the dividend pursuant to Code section 901 in addition to any of the underlying foreign tax associated with the earnings and profits of the foreign corporation that paid the dividends pursuant to Code section 902.

79 See the discussion below under the heading "Conversion of a Stock Reorganization into a Transfer of Assets for US Income Tax Purposes" on the US tax treatment of the contribution of the foreign subsidiaries by USco to F1 and F2, followed by a check-the-box election to have them treated as disregarded entities.

80 Temp. Treas. reg. section 1.704-1T(b)(1)(ii)(b) deals with partnership allocations of foreign expenditures. The temporary regulations should not affect this planning.

81 Articles 13(4) and (5) of the Convention Between the Government of Canada and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Luxembourg on September 10, 1999.

82 Any US person that owns directly, or indirectly, 10 percent or more of the shares of a CFC is taxable immediately on its share of any subpart F income earned by the CFC.

83 For an analysis of the recharacterization of a transaction as a contribution of assets, see Rev. rul. 67-274, 1967-2 CB 141; PLR 9327010, March 23, 1993; and Rev. rul. 2004-83, 2004-2 CB 157.

84 Code section 165(g).

85 Rev. rul. 2003-125, 2003-2 CB 1243.

86 Ibid.

87 Code section 1504(a)(2).

88 Code section 165(g)(3).

89 For example, for the purpose of establishing the value of the underlying assets, a valuation should be obtained. "All" assets (including intangibles) that may not appear on the balance sheet (for example, goodwill) are to be included in the valuation. If the holder of the shares has advanced amounts to the foreign subsidiary and those amounts are characterized as debt for the purposes of the calculations, the true nature of those amounts must be confirmed; if the amounts are treated as equity for US tax purposes, there is a possibility that the corporation is solvent, in which case E & P may be recognized as a dividend in the course of the dissolution pursuant to Code section 367(b).

90 Code section 954(c)(1)(B).

91 Treas. reg. section 1.954-2(e)(1).

92 Code section 332.

93 Internal Revenue Service Technical Assistance 199937038, June 28, 1999.

94 Notice 2003-46, 2003-2 CB 53, indicating the intention to withdraw the proposed regulations, and Announcement 2003-78, 2003-2 CB 1172, withdrawing those regulations.

95 *Dover Corporation and Subsidiaries*, 122 TC 324 (May 5, 2004).

96 1975-1 CB 109.

97 United States, Staff of the Joint Committee on Taxation, *Options To Improve Tax Compliance and Reform Tax Expenditures*, JCS-2-05 (Washington, DC: Joint Committee on Taxation, January 27, 2005), 182-85.

98 Subsection 18(4) of the ITA.

99 This will have no tax consequence to the vendor so long as the vendor is not subject to US tax. If the vendor is subject to US tax, there could be an income inclusion to the vendor if the recognition of any of the income in the target will give rise to subpart F income. There will be no income inclusion to the target so long as it does not have any assets that are effectively connected with a US trade or business.

100 If the target is not already in the jurisdiction in which the ULC has been formed, it will have to be continued into Alberta or Nova Scotia, as the case may be.

101 Section 212.1 of the ITA is not an issue, since a Canadian corporation was used as the vehicle to acquire the shares in the target. Section 212.1 becomes an issue if USco acquires the shares in the target directly and then tries to step up the paid-up capital in the target to the cost in the shares by a transfer of those shares to another Canadian corporation.

102 Treas. reg. section 1.901-2(f)(1) provides that the person by whom tax is considered paid for the purposes of claiming a direct foreign tax credit in Code sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax, even if another person (for example, a withholding agent) remits such tax.

103 The disconnect between the foreign tax credit and the related taxable income (that is, the nonrecognition of the related income for US tax purposes) was considered in *Guardian Industries Corp. & Subs v. US*, 95 AFTR 2d 2005-1692 (Ct. Fed. Cl., March 31, 2005). The court in that case permitted a refund claim by the plaintiff for a direct foreign tax credit for the Luxembourg tax that was paid or incurred by the Luxembourg parent in respect of other consolidated Luxembourg corporations, even though the Luxembourg parent did not have to recognize the income of those corporations under Luxembourg law.

104 Treas. reg. section 1.1441-4(a).

105 Paragraph 212(13.1)(a) of the ITA will not deem the partnership to be a resident of Canada for the purposes of the withholding tax provisions so long as the partnership does not have income from a source in Canada. However, in CRA document no. 2003-0039231E5, May 25, 2004, the CRA wrote that although paragraph 212(13.1)(a) is not applicable, the interest paid by a partnership with Canadian resident partners to a US bank could still be subject to Canadian withholding tax, even though the partnership does not have Canadian-source income, if the partnership can be looked through and it is the partners that owe the debt and who pay the interest.

106 Subparagraph 95(2)(a)(ii) of the ITA.

107 Paragraph 113(1)(a) of the ITA and related regulations.

108 The difference in the Canadian and US tax characterization of the residence of a partnership is discussed below under the heading "Canadian Partnership."

109 Subsection 112(1) of the ITA permits a corporation to deduct from its income an amount equal to the amount of a dividend "received" from a taxable Canadian corporation. The question of whether corporate partners are able to claim the deduction under subsection 112(1) in respect of dividends allocated from a partnership (that is, whether the dividends are received) was answered in the affirmative in CRA document no. 2003-0027745, September 18, 2003. For a fuller discussion of why a partner should be treated as receiving a dividend through a partnership when the amounts are not credited to the partner's account, see Brian Felesky and John Burghardt, "Oil and Gas Taxation: Developments and Issues" (2004) vol. 17, no. 1 *Canadian Petroleum Tax Journal* 49-91. Under the limited partnership laws of most states, a US limited partnership is generally treated as a person separate from its members for nearly all purposes.

110 See CRA document no. 2003-0048251E5, July 14, 2005.

111 Designated income is, effectively, the taxable gains and losses on taxable Canadian property, income from real property (other than Canadian resource property, timber resource properties, and Canadian resource properties), and income from businesses carried on in Canada.

112 Paragraph 153(1)(g) of the ITA and regulation 105(1) of the Income Tax Regulations.

113 The arrangement must be carefully structured to counter the argument that the ULC is acting as an agent or nominee of the US shareholder.

114 If the US lessor is an LLC, the applicable rate of Canadian withholding tax would be 25 percent: the Canada-US income tax convention is not applicable because the LLC is not treated as a resident of the United States for the purposes of the convention unless it checks the box to be treated as a corporation.

115 The applicable rate of withholding tax will depend on the status of the US person for treaty purposes. If the US person is an LLC, the rate of withholding is 25 percent. If the US person is an individual, an S corporation, a qualified subchapter S subsidiary, a C corporation, or a partnership, all of the members of which are US residents for treaty purposes, the applicable rate of withholding tax is 10 percent.

116 It is important that neither of the two Canadian corporations own directly 80 percent or more of the shares of the Canadian target; otherwise, there will be no basis step-up because of the operation of Code section 332, which would result in a carryover of the existing basis in the assets.

117 Treas. reg. section 301.7701-3(g)(1)(ii).

118 Treas. reg. section 1.951-1(a).

119 Code sections 964(e) and 1248 treat a gain realized on the shares of a foreign corporation transferred by a CFC as a dividend subject to subpart F to the extent of the E & P in the foreign corporation. However, section 1248 is not applicable in this case so long as the shares are held for less than one year pursuant to the exception in Code section 1248(g)(2)(C).

Accordingly, any gain on the shares that accrues on the shares during the transition period should not be converted into a dividend.

120 In such a case, the individual vendor can transfer the shares in Canco to a Canadian trust in which it is the sole beneficiary. A limited company will be the trustee of the trust and will therefore be the shareholder of Canco when it is converted into a ULC. The vendor can realize the gain on the transfer to the trust (sufficient measures should be undertaken to ensure that the transaction with USco will close) or, alternatively, the shares in Canco can be transferred to an alter ego trust and the gain deferred until the shares in the ULC are sold by the trust. The trust arrangement must be structured in such a manner that the trustee will not have a right of indemnity against the vendor, as a beneficiary, or be considered a nominee of the vendor.

121 In effect, a US person can avoid immediate taxation on the exchange of one property for another property. These rules are much broader than the replacement-property rules in the ITA.

122 See, for example, PLR 199911033, March 22, 1999.

123 The definition of "immovable property" is narrower in the Canada-Luxembourg income tax convention than it is in the Canada-US tax convention because under the latter convention the shares are tainted regardless of whether or not the immovable property is used in the business of the ULC.

124 For another description of this type of arrangement, see John M. Ulmer, "Cross-Border Financing Structures for Inbound Investment," in *Report of Proceedings of the Fifty-Sixth Tax Conference*, 2004 Conference Report (Toronto: Canadian Tax Foundation, 2005), 17:1-45, at 17:32-34; and Jim McKee, "Café Annie's Tasty Inbound Financing" (2002) vol. 15, no. 1 *Canadian Petroleum Tax Journal* 67-87.

125 The loan will not be subject to Canadian withholding tax by virtue of subparagraph 212(1)(b)(vii) of the ITA if the borrower is not obligated to repay more than 25 percent of the principal amount of the loan within the first five years from the date of issue.

126 Other structures deal with the payment of interest by having the interest payments under the hybrid note payable in cash and having the forward purchase agreement extend to the interest obligation with a commitment imposed on USco to subscribe for further common shares in Canco in an amount equal to the interest payable under the hybrid note. For a more detailed discussion of the question whether interest paid in shares is deductible under paragraph 20(1)(c) of the ITA, see Brian D. Segal, "Non-Residents Investing in and Disposing of Canadian Rental Real Estate," in *1998 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 1998), tab 5. The Tax Court's recent decision in *Alcatel Canada Inc. v. The Queen*, 2005 TCC 149, at paragraphs 25-33, should also be considered along with the cases referred to by Segal, supra, at 56-60.

127 Attempts by some judges to recharacterize several transactions or properties into one have become less and less common over the past 10 years, thanks in large part to the Supreme Court of Canada's decisions in cases such as *Shell Canada Ltd. v. The Queen*, [1999] 3 SCR 622, at paragraphs 19 and 41, and *The Queen v. Singleton*, [2001] 2 SCR 1046, at paragraphs 33-35. In *Singleton*, the attempt by the Federal Court of Appeal to consider one legal document (the debenture agreements) together with another legal document (the forward exchange contract) in determining the deductibility of interest was completely shut down on appeal to the Supreme Court. In recent years, though, the Federal Court of Appeal has enforced the legal reality doctrine. See, for example, *The Queen v. Canadian Pacific Ltd.*, 2001 FCA 398, at paragraphs 32-33; *Novopharm Ltd. v. The Queen*, 2003 FCA 112, at paragraphs 7-13; and, more recently, *Rezek v. The Queen*, 2005 FCA 227, at paragraphs 34-52.

128 Subpart F income inclusion cannot exceed the E & P of a CFC.

129 A CFC is, on a company-by-company basis, provided with a maximum $1 million exemption from subpart F income under Code section 954 (b)(3)(A). The effect of combining a number

of CFCs through a check-the-box election may cause the aggregate subpart F income to exceed the maximum $1 million exemption when such income, calculated on a company-by-company basis, could have otherwise been exempt from subpart F income if each amount earned by a CFC did not exceed $1 million.

130 Code section 954 (b)(3)(B) provides that if the sum of foreign base company income and gross insurance income for the taxable year of a CFC exceeds 70 percent of its gross income, the entire gross income for the taxable year will be treated as foreign base income or insurance income, as the case may be.