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June 27, 2003

Jobs and Growth Tax Relief Reconciliation Act of 2003 – Effect on U.S. Investment in Canadian Corporations and Income and Royalty Trusts

Recent United States tax legislation may have a significant impact on U.S. investment in Canadian corporations and Canadian income or royalty trusts.

On May 28, 2003, President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "Act"). One of the centerpieces of the bill is a tax rate reduction for individuals on certain dividends and long-term capital gains to 15%.[1] (Formerly, for individuals, rates of up to 38.6% applied to dividends and, in general, a 20% rate applied to long-term capital gains). The taxation of short-term capital gains and interest remains unchanged, as does the taxation of U.S. corporate investors.

Unlike earlier versions of this proposal, the Act extends the reduced rate to certain dividends paid on stock of non-U.S. issuers. This change may benefit many Canadian issuers seeking to raise capital from U.S. individuals and perhaps others.[2]

I. New Dividend Rules

The Act's 15% tax rate applies to dividends paid by non-U.S. corporations (and entities treated, for U.S. tax purposes, as non-U.S. corporations) if:

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1 The dividend rate change is generally effective January 1, 2003; the capital gain change is effective for dispositions after May 5, 2003. The rate change provisions have "sunset dates" (2009 for dividend and capital gain changes). It is not possible to predict whether these will be extended.

A distribution is a "dividend" for U.S. tax purposes if it is made out of the issuer's accumulated or current "earnings and profits," as calculated for U.S. tax purposes. A distribution will only be potentially eligible to be taxed at the 15% rate only to the extent it qualifies as a "dividend."

Note that the Act also provides for a potentially complex adjustment to the recipient's foreign tax credit calculation that takes into account the fact that the dividend is more lightly taxed. The precise impact of this adjustment will depend on a recipient's individual circumstances.

2 For example, the beneficial dividend rate flows through mutual funds to individual shareholders, thus the new legislation may make non-U.S. equities marginally more attractive to these institutions.

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A. one of the following two tests is met:

(i) the stock on which the dividend is paid is readily tradable on an established U.S. securities market in the United States (the "U.S. Publicly Traded Test"), or

(ii) the corporation is eligible for benefits under a U.S. income tax treaty that meets certain requirements (the "Treaty Test");[3]

and

B. the corporation does not fall within certain U.S. anti-deferral regimes.

A. The U.S. Publicly Traded Test and the Treaty Test

Shares of a Canadian issuer that are listed and actively traded on a U.S. market will satisfy the U.S. Publicly Traded Test. It is unclear whether stock that is not so listed but is otherwise readily tradable (for example, through U.S. interdealer quotation system other than Nasdaq) would also qualify. Note that meeting the U.S. Publicly Traded Test is relevant only for dividends paid on the U.S. publicly traded class (or classes) of shares.

Most Canadian public corporations (and certain others) will satisfy the Treaty Test. A Canadian corporation is eligible for the benefits of the U.S.-Canada income tax treaty (the "Treaty")[4] in the first instance because it is subject to income tax in Canada by reason of its residence, but in order to meet the Treaty Test it must also satisfy the requirements of the Treaty's "limitation on benefits" article. Canadian corporations whose principal class of shares regularly and substantially trades on a recognized stock exchange in the U.S. *or* Canada will qualify. Recognized stock exchanges include the NYSE, AMEX, Nasdaq and any Canadian stock exchange that is a "prescribed stock exchange" under the Canadian Income Tax Act. A non-public Canadian corporation may also meet limitation of benefits article, and thus the Treaty Test, if it can demonstrate more than half of its stock (by vote *and* value) is held by certain U.S. and Canadian persons and it meets a "base erosion" test or, under certain circumstances, it is engaged in an active trade or business in Canada. Certain provisions of U.S. internal law (e.g., the "hybrid entity" and "check-the-box" rules) may also be relevant under the Treaty test, but these generally will not be an issue except in the case of unlimited liability companies. Note that if a Canadian corporation meets the Treaty Test, and is not subject to any of the anti-deferral regimes described below, then dividends on all of its stock (not just publicly traded classes) will qualify for the new rules.

B. Anti-Deferral Regimes

The 15% rate is not available to dividends paid by an issuer that is classified under U.S. tax law as a "passive foreign investment company," "foreign investment company" or "foreign personal holding company" for the taxable year in which the dividend is paid or the preceding taxable year. Each of these categories involves complex definitions and analyses, and while all are generally aimed at

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[3] The legislative history appears to add the requirement that the issuer must qualify for the benefits of the treaty with respect to substantially all of its income in the taxable year in which the dividend is paid. The full implications of this requirement are not clear in some situations.

[4] Article XXVII of the Treaty satisfies Congress' requirement that the treaty in question contain an exchange of information program.

companies with largely passive income, they can apply in unanticipated settings. For example, there is a risk that the passive foreign investment company rules may apply to seemingly active companies ranging from high-tech startups to certain natural resource businesses, and they may also apply in certain circumstances to a U.S. shareholder of a corporation that is no longer, but was once, a passive foreign investment company. These issues should be reviewed in each case.

II. Application to Income and Royalty Trust Units

A Canadian income trust or royalty trust (both referred to herein as "Income Trusts") is treated as a corporation for U.S. tax purposes, unless it has made a U.S. tax election to be treated as a partnership.[5] Distributions from an Income Trust that is classified as a corporation for U.S. tax purposes are thus treated as "dividends" (to the extent of the payor's "earnings and profits"), and therefore may be eligible for the 15% tax rate under the rules set forth above.

The U.S. Publicly Traded Test will apply to Income Trusts in the same manner as described above. The application of the Treaty Test, however, is less certain. Under the Treaty, a Canadian trust is eligible for benefits only to the extent that income of the trust is liable to tax in Canada, either at the trust level or beneficiary level. It is not clear that this test will be met by an Income Trust that distributes income to beneficiaries if more than a *de minimis* number of units are held by non-taxpayers [e.g., tax-exempt pension plans or, conceivably, non-Canadian holders (although, in the case of non-Canadian holders, the better reading would seem to be that the Treaty should apply if there is in fact Canadian withholding)]. If the basic treaty requirement is met, neither the limitation on benefits provision nor the U.S. hybrid entity rules should deny Treaty benefits to an Income Trust that is publicly traded in the U.S. or Canada.

Like regular corporations, Income Trusts' dividends will only be eligible for favorable dividend treatment if the anti-deferral regimes described in Part I above do not apply to the issuer in the current or immediately preceding taxable year. These rules (particularly the PFIC rules) will need to be examined carefully in each case.

Because Income Trusts are potentially eligible, subject to the above-noted uncertainty in the application of the Treaty, to pay dividends taxable at the 15% rate, one consequence of the Act may be to render elective partnership status less attractive: if Income Trusts unit holders are treated as partners for U.S. tax purposes, they will be taxed on their share of the trust's income at higher ordinary income rates.

If you have any questions concerning the foregoing, please call our tax partners David R. Sicular at (212) 373-3082 or Richard J. Bronstein at (212) 373-3744 or our securities partners Edwin S. Maynard at (212) 373-3024 or Andrew J. Foley at (212) 373-3078.

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[5] Many, but by no means all, Canadian oil and gas royalty trusts that have significant U.S. ownership have made the partnership election.