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Canada Revenue Agency Frowns Upon the Use of US LLPs and LLLPs

The Canada Revenue Agency (the "**CRA**") recently delivered an unwelcome message to Canadian residents that invest in the United States through partnerships constituted as "limited liability partnerships" ("**LLPs**") or "limited liability limited partnerships" ("**LLLPs**"). Canadian investors will need to promptly consider the best means of mitigating the impact of the CRA's new position on the characterization of US LLPs and LLLPs.

Background

The laws of many US states permit the registration of several different types of partnerships, each with unique attributes and varying degrees of liability protection afforded to individual members.

1. LLPs

The US LLP, a special form of general partnership, first gained prominence among lawyers and accountants 25 years ago. In the late 1980s, volatility in the real estate and energy markets in Texas led to the collapse of a significant number of banks and "savings and loans". With the insolvency of such financial institutions, creditors increasingly made claims against the accounting and law firms that previously advised the institutions. Under the prevailing partnership law at the time, each member of those firms that were constituted as partnerships was liable for such claims, irrespective of whether the

particular partner had rendered any services to the relevant institution.

The fallout from the banking and "savings and loan" crisis led to the introduction of LLP legislation, beginning in Texas in 1991, which recognized a special form of partnership, an LLP, members of which would not generally be liable for damages and obligations arising from the negligence or malfeasance of another member of the partnership.

Over time, LLP legislation in certain US states began to permit partnerships conducting businesses other than the provision of professional services to be registered as LLPs. Certain LLP legislation also extended limited liability protection to cover most debts and obligations of the partnership, not just those attributable to the negligence or wrongful acts of a fellow partner. Virtually all US states now permit the registration of LLPs.

2. LLLPs

In the late 1990s, certain US states went a step further and began to permit limited partnerships to be registered as LLLPs.

An LLLP is a limited partnership that has made an appropriate registration with the relevant state authority to be characterized as an LLLP. As a limited partnership, an LLLP has one or more general partners that are responsible for managing the affairs of the partnership and one or more passive, limited partners that do not play an active role in the management of the partnership. Absent registration as an LLLP, the general partner of a limited partnership is liable for the debts and obligations of the partnership, while the limited partners that do not participate in the management of the partnership generally enjoy limited liability in respect of such debts and obligations.

The ability to register a limited partnership as an LLLP has been added to the partnership legislation in approximately one-half of all US states. LLLP legislation provides that no partner of the LLLP, whether they be a general or limited partner, is liable for the debts and obligations of the partnership.

Two of the principal advantages cited in favour of registering a limited partnership as an LLLP are (i) the avoidance of the need to

incorporate a special purpose company to serve as the general partner of the partnership (which would be subject to the debts and obligations of the partnership), and (ii) the ability to relieve all partners of exposure to the liabilities and obligations of the partnership (i.e., both general partners and limited partners that participate in the management of the business of the partnership).[1]

In recent years, the registration of US partnerships as LLPs or LLLPs has become increasingly commonplace.

Canadian Tax Characterization of LLPs and LLLPs

The CRA typically applies a two-step approach to determining whether a particular foreign legal relationship should be characterized as a partnership or a corporation for Canadian tax purposes. First, the CRA generally examines the characteristics of the foreign relationship, as provided under both the applicable foreign law and the agreement(s) governing the relationship, to ascertain its operative characteristics. Thereafter, the CRA compares the characteristics of the foreign relationship with the characteristics of relationships known under Canadian law to determine whether the foreign relationship more closely resembles a Canadian corporation or a Canadian partnership.

Historically, the CRA had not overtly contested the characterization of US LLPs and LLLPs as partnerships for Canadian income tax purposes. However, at a meeting of the International Fiscal Association ("**IFA**") in May of 2015, the CRA announced that it was reviewing the proper characterization of LLPs and LLLPs formed under the laws of the State of Florida. The CRA subsequently indicated that it was the agency's preliminary impression that such partnerships should possibly be characterized as corporations for Canadian income tax purposes.

New CRA Position

At a meeting of IFA in Montréal on May 26, 2016, the CRA announced that the agency had concluded that LLPs and LLLPs

[1] However, several commentators have noted that the liability limitation offered under LLLP legislation has yet to be tested in the courts. Moreover, when operating in those states that do not formally recognize "foreign" LLLP legislation, there is some question as to the degree to which one should rely on the added liability protections ostensibly offered by an LLLP relative to a conventional limited partnership. As a consequence, the advantages afforded by LLLP legislation may, from a practical perspective, often be more incremental than fundamental.

formed under the laws of the States of Delaware and Florida more closely resembled corporations than partnerships and should be characterized as such for Canadian tax purposes. The CRA placed considerable weight on the fact that LLPs and LLLPs formed under the laws of the two states appear to have a separate legal personality and that members of such partnerships are entitled to extensive limited liability protection.

The CRA's new announcement will effectively result in LLPs and LLLPs formed under the laws of the States of Delaware and Florida being treated by the CRA no differently than limited liability companies formed under US law.

While the CRA has not formally stated that its new position will apply to LLPs and LLLPs formed under the laws of other US states, it has indicated that the reasoning underlying its recent announcement may be applicable in respect of LLPs and LLLPs constituted under other state laws.[2]

Implications

Subject to the transitional relief described in greater detail below, Canadian resident members of most US LLPs and LLLPs will be required to report their equity investments in such partnerships as share investments in a corporation, rather than as interests in a US partnership.

In the past, Canadian investors will have typically included the business income allocated from such partnerships in their own taxable income for Canadian tax purposes, and will have sought to claim a Canadian foreign tax credit in respect of US taxes paid on the allocated income. However, such reporting will no longer be permitted under the CRA's new interpretive approach.

Although Canadian investors will continue to be subject to US taxation in respect of income allocated from LLPs and LLLPs, the CRA will now consider the earnings of the partnership to instead be taxable at the US corporate level. As a consequence, a Canadian investor's ability to claim a foreign tax credit or deduction in respect of such US tax will be restricted.

The timing of Canadian taxation in respect of the earnings of a US LLP or LLLP will be dependent on when distributions are made by the

[2] See CRA Technical Release 2016-0642051C6 (26 May 2016).

partnership, which will frequently lead to cross-border tax inefficiencies and instances of double taxation.

The spectre of heightened or double taxation will demand that Canadian investors in US LLPs and LLLPs reassess the prudence of their investments.

The CRA's new interpretive position may also have adverse historical implications for existing members of US LLPs and LLLPs. To the extent that the CRA seeks to apply its new position to existing partnerships, past failures by Canadian members to properly account for distributions made by the partnership, or the US taxes paid in respect of the income of the partnership, may invite significant additional tax, penalties and interest.

To mitigate the impact of the CRA's announcement, Canadian investors in a US LLP or LLLP may wish to advocate for the conversion of the partnership into a conventional US limited partnership that is recognized as a partnership by the CRA for Canadian tax purposes. The operative statutes in most US states permit such a conversion on a relatively efficient (and potentially tax-free) basis through a simple filing. Unfortunately, in many instances, minority Canadian investors in an LLP or LLLP will lack the legal ability or economic influence to compel the conversion of the LLP or LLLP into a conventional limited partnership. In addition, where conversions are practically feasible, care will need to be taken to ensure that the transitional relief described below applies in respect of the LLP or LLLP, so as to ensure that the CRA does not take the position that the relevant Canadian investor has disposed of its interest in a corporation, and reacquired an interest in a partnership, for Canadian tax purposes.

Transitional Relief

The CRA has announced that it will offer transitional relief in respect of certain US LLPs and LLLPs, which will allow for such entities to be treated as partnerships retroactively from the time of their formation, so long as the relevant arrangements do not amount to "abusive tax avoidance" and the following conditions are satisfied:

1. Neither the LLP/LLLP, nor any of its members, has ever taken the position that the LLP/LLLP was anything other than a partnership for Canadian income tax purposes;

2. The partnership was formed and carried on business prior to July, 2016, and was not previously constituted as an LLC that was subsequently converted into an LLP or LLLP;

3. The members of the partnership intended that the entity was to be treated as a partnership from the time of its formation for Canadian tax purposes; and

4. Prior to 2018, the LLP/LLLP is converted into some other relationship that the CRA recognizes as a partnership.

Required Future Actions

Any Canadian taxpayer that is a member of a US LLP or LLLP should carefully assess the income tax consequences of the CRA's new administrative position and chart out ameliorative steps as soon as possible. Such Canadian taxpayers should also determine whether they are entitled to claim the benefits of the CRA's transitional relief, as well as identify any past reporting or compliance deficiencies, the consequences of which could potentially be mitigated by a voluntary disclosure.

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