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Canadians Who Invested in U.S. LLPs and LLLPs Need to Rethink Their Choice of Entity

by William A. Kastin, Roy A. Berg and Kim G C Moody

I. Summary

Historically, Canadian investors in U.S. partnerships benefitted from an extremely efficient income tax structure – i.e., a single level of tax, credit against Canadian taxes for taxes paid in the U.S., and an ability to qualify for Treaty[1] benefits. Unfortunately, as a result of a recent development, Canadian investors will no longer benefit from these efficiencies with respect to their investments in U.S. LLPs and LLLPs.[2] Instead, those investors will be treated, for Canadian tax purposes, as investing in a U.S. corporation – resulting in multiple levels of tax, the possibility that Canada will not grant foreign tax credits ("FTCs") for taxes paid in the U.S., and the further possibility that Canadian investors will not be able to avail themselves of the benefits under the Treaty. Fortunately, as discussed below, many Canadian investors may restructure their U.S. investments so that they are not adversely affected by this recent development.

II. LPs and LLCs

Often times Canadians investing in the U.S. would do so by holding a direct or indirect interest in a U.S. limited partnership ("LP"). The U.S. LP gave Canadian individuals several benefits. Most notably, because the LP is generally treated as a flow-through entity for both Canadian and U.S. tax purposes, the LP itself was not subject to U.S. tax. Instead, as a result of flow-through treatment, income and loss derived by the LP would simply flow through the LP to the Canadian investor, and the Canadian investor would, in turn, pay a single level of tax on its share of LP net income. In these instances, in addition to any filing and tax payment requirements in Canada, the Canadian investor, on an annual basis, would have to pay U.S. taxes (with appropriate Canadian FTCs and / or deductions being claimed for Canadian purposes) and file U.S. tax returns. For many Canadian investors, these U.S.-based requirements were an acceptable price to pay in exchange for an efficient cross-border tax structure.

> Example #1: Canadian Investor "C" invests in a U.S. LP that generates business income and, in Year 1, is allocated $100 of ordinary income and receives a $100 cash distribution. As a result, C would file a U.S. tax return and pay approximately 39.6% in U.S. federal income taxes to the Internal Revenue Service ("IRS"), totaling $39.60[3]. In Canada, with respect to the same $100 of ordinary income, C would owe a tax of $50, based on a Canadian tax rate of 50%.[4] However, in filing its Canadian tax returns, C generally would be entitled to a foreign tax credit in an amount equal to what C paid in U.S. taxes on the same $100 of LP income. As a result, C's Canadian tax liability of $50 would be reduced by the $39.60 that C paid to the IRS, and the balance due by C to the Canada Revenue Agency ("CRA") would be $10.40. In the end, C would pay a total of $39.60 to the IRS and $10.40 to CRA – resulting in an effective tax rate of 50%, and yielding $50 of net-after-tax dollars.

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[1] References to the Treaty are to the Canada-United States Tax Convention (1980) as amended by the fifth protocol dated September 21, 2007.

[2] LLPs and LLLPs refer to limited liability partnerships and limited liability limited partnerships. As described more fully in this article, LLPs and LLLPs are U.S. state law variations of the traditional limited partnership.

[3] State taxes and other taxes are ignored for purposes of this example.

[4] Federal and provincial taxes combined. Foreign currency issues are ignored, and it is assumed that US$1 = C$1 but, of course, we know that such an assumption is false.

In the U.S. the use of limited liability companies ("LLCs"), which can be treated as partnerships for U.S. federal income tax purposes, has become quite common over the past twenty years.[5] With respect to the matters pertinent to this article, one of the main differences between an LP, on the one hand, and an LLC, on the other, can generally be stated as follows:

- When forming an LP, there is at least (i) one limited partner and (ii) one general partner, and the general partner has unlimited liability respecting the liabilities of the LP.
- In comparison, when forming an LLC, there are at least two members, and neither of them is liable for the liabilities of the LLC.

In general, for many U.S. investors, the difference between (i) an LLC, treated as a partnership for U.S. tax purposes, and (ii) a limited partnership, is relatively insignificant, or at least manageable. That is, for a U.S. investor, the LP and the LLC are, in many respects, interchangeable. However, for Canadian investors the two entities yield drastically different results.

As many Canadians know, whereas CRA treats U.S. LPs generally the same as Canadian LPs (i.e., allowing flow-through treatment of LP income and loss, a single level of tax at the partner-level, and generally affording Treaty benefits for Canadian individual partners), CRA treats LLCs quite differently. Specifically, CRA treats LLCs as foreign corporations for Canadian tax purposes. The result to a Canadian investor in an LLC is relatively unpleasant, but can be explained in a straight forward manner – no flow-through taxation, resulting in an inefficient cross-border tax structure.

> <u>Example #2</u>: Canadian Investor "C" invests in an LLC and, in Year 1, is allocated $100 of ordinary business income but does not receive the $100 in the form of a cash distribution. The LLC is treated as a partnership for U.S. federal income tax purposes, but as a corporation for Canadian tax purposes. As a result, C files a U.S. tax return and pays approximately 39.6% in U.S. federal income taxes to the IRS,[6] *i.e.*, similar treatment as C enjoyed when investing in an LP, described above in Example #1. In Canada, there would be no income inclusion since there was no corresponding cash distribution (which Canada treats as a dividend from a foreign corporation).[7] Accordingly, there would be no ability for the Canadian investor to claim the US tax paid as an FTC given the fact there was no foreign source income to include in income. In a later year, when the cash is ultimately distributed from the LLC to the Canadian investor, Canada would charge tax on the foreign source dividend at a 50% rate. Given such, it is usually important to try and time the income allocations/inclusions and cash distributions from the LLC carefully so as to ensure maximum utilization of FTCs and avoid double taxation. In this example, the effective tax rate on the $100 of income generated from the LLC would be 89.6%, and yielding $11.40 of net after-tax dollars - ouch!

III. LLPs and LLLPs

Based on the discussion above, the simple take-away for Canadian individuals investing in the U.S. is fairly straight forward: "U.S. LP = good; LLC = bad." Unfortunately, LPs and LLCs are not the only two choices available. Approximately half the states in the U.S. have statutes allowing for the formation of not only LPs, but for variations of the LP referred to as limited liability partnerships ("LLPs") and limited liability limited partnerships ("LLLPs").[8]

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5 All references in this article to an LLC presumes that the LLC is a multi-member LLC, which is treated as a partnership for U.S. federal income tax purposes.
6 State taxes and other taxes are ignored for purposes of this example.
7 This statement assumes that the income of the LLC would not be considered "Foreign Accrual Property Income" for Canadian purposes.
8 See, e.g., Arizona, Delaware, Florida, Nevada, and Washington. Interestingly, although California state law does not contemplate the formation of a California LLLP, California does recognize LLLPs formed in other states.

The main difference between LLPs and LLLPs on the one hand, and LPs on the other, can generally be stated as follows:

- As mentioned above, when forming an LP, there is at least (i) one limited partner and (ii) one general partner, and the general partner has unlimited liability respecting the liabilities of the LP.
- When forming an LLP or LLLP, there is similarly at least (i) one limited partner and (ii) one general partner, but with these entities the general partner has some protection from being liable for all of the liabilities of the LLP or LLLP.

With respect to categorizing entities which have at least one partner, i.e., the general partner, that has unlimited liability for the entity's liabilities, the LLP and LLLP are more similar to the LLC than they are to the LP. That is, when dealing with LLCs, LLPs and LLLPs, no member or partner bears the economic risk of loss for all of the entity's liabilities. In comparison, when dealing with an LP, the general partner bears the economic risk of loss for all of the entity's liabilities. And this distinction appears to be exactly what CRA focused upon this past May when it announced that it will start to treat Delaware and Florida[9] LLPs and LLLPs as corporations for Canadian income tax purposes.[10]

IV. Next Steps

At right about this time, many Canadian investors reading this article are thinking, "I honestly can't remember if I've invested in a U.S. LP, an LLP, or an LLLP. But assuming I've invested in an LLP or an LLLP, is there anything I can do to avoid the horrid and inefficient result illustrated in Example #2 above?" And the answer is, "Yes."

When CRA announced how it would start treating LLPs and LLLPs, it realized that many Canadians would be caught off-guard and in a difficult position. And so, CRA stated the following at some recent tax conferences:

> *"[W]e believe it has become widely accepted that U.S. limited liability companies ("LLCs") are properly viewed as corporations for the purposes of [Canadian income tax law] . . . . We see little substantive difference between LLPs, LLLPs and LLCs governed by the laws of the states of Florida and Delaware. As such, we have reached the general conclusion that Florida and Delaware LLPs and LLLPs should be treated as corporations for the purposes of Canadian income tax law."*

At the same time, in order to promote fairness and predictability, CRA acknowledged the difficulties that may be created by its newly announced position and expressed its desire to make certain administrative concessions in this regard. Specifically, CRA announced that, in the absence of abusive tax avoidance, CRA was prepared to accept that an LLP or LLLP be treated as a partnership for the purposes of Canadian income tax law from such entity's time of formation if each of the criteria set forth below were satisfied:

1. The entity is formed and begins to carry on business before July 2016;
2. It is clear from the surrounding facts and circumstances that the members
    - are carrying on business in common with a view to profit; and
    - intended to establish an entity that would be treated for Canadian income tax purposes as a partnership and not a corporation;

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[9] Although no one factor is determinative, CRA indicated that an LLPs and LLLPs separate legal personality and extensive limited liability were of overwhelming significance.
[10] The authors of this article do not agree with CRA's position or, necessarily, with its rationale.

3. Neither the entity itself nor any member of the entity has ever taken the position that the entity is anything other than a partnership for Canadian income tax purposes; and

4. The entity converts, before 2018, to a form of entity that is generally recognized as a partnership for Canadian income tax purposes.

Any LLPs or LLLPs which do not meet the criteria set forth above generally will be dealt with on a facts and circumstances basis.[11] Indeed, CRA reminded taxpayers and practitioners that its statements were general views only and that the *classification of a particular entity is a question of fact.*

Of the four criteria mentioned above, the fourth is the only one over which a Canadian investor has any actual current control. Canadian investors would be wise to reach out to their Canadian and U.S. tax advisors to discuss the most prudent course of action to take in the near future. Specifically, if you have invested in an LLP or LLLP, you need to first determine whether the LLP or LLLP qualifies for the retroactive partnership treatment described above. And, assuming the entity so qualifies, you need implement the necessary changes. Just like CRA's new position could have adverse effects on Canadian investors, converting from an LLP or LLLP into an LP may have adverse effects on some or all of the partners. Therefore, careful planning should be taken to ensure that, to the extent possible, in relation to any conversion from an LLP or LLLP to an LP, none of the partners of the converting entity are put in a worse position than any of the parties intend or anticipate.

[11] CRA was very specific that notwithstanding its desire to accommodate partners of LLPs and LLLPs who are reacting to CRA's newly stated position, CRA generally will not accept partnership treatment of an entity which started out as an LLC, and then converted to an LLP or LLLP.

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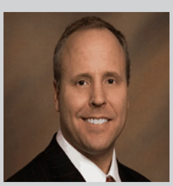
Bill Kastin's practice concentrates on problem solving and comprehensive planning for individuals, corporations (including S corporations), partnerships and LLCs. He works with the client's leadership team to identify, create and help implement strategies that achieve the desired results in an efficient manner while being respectful of the client's business culture. Among others, Bill advises the firm's non-U.S. clients on the U.S. tax implications of their U.S. investments (inbound transactions), and the firm's U.S. clients on the U.S. tax implications of their foreign investments (outbound transactions). Bill is rated as AV® Preeminent™, the highest rating given by Martindale-Hubbell's® Peer Review Ratings™ system.



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