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CANADA REVENUE AGENCY NOW TREATS U.S. LLPS AND LLLPS AS CORPORATIONS

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In public pronouncements culminating in its answer to a question posed at the 2016 International Fiscal Association Roundtable, the Canada Revenue Agency (CRA) has taken the position that Florida and Delaware limited liability partnerships (LLPs) and limited liability limited partnerships (LLLPS) will be treated by it as corporations for Canadian income tax purposes.¹ As it is likely that the salient features of Florida and Delaware LLPs and LLLPS are comparable to those of similar partnerships in other U.S. states, this CRA position is expected to have a broad impact.

While the merits of CRA's position can be debated, affected taxpayers must deal with the practicalities. In this context, the CRA has agreed to provide administrative relief for LLPs and LLLPS that convert to a form recognized by CRA as a partnership (a general partnership or a limited partnership) before 2018, provided certain other requirements are met as discussed below.²

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¹ Dave Beaulne, Answer to Question #1 from the International Fiscal Association, Canadian Chapter, Roundtable (May 26, 2016) ("Classification of U.S. LLPs & LLLPS") (edited transcript available at <https://taxinterpretations.com/content/367354#Q1>).

² See response to question "Can you provide any administrative relief" from Dave Beaulne, *id.*

CANADIAN APPROACH TO FOREIGN 'ENTITY' CLASSIFICATION

Before the CRA's latest announcements, Canada's approach to foreign 'entity' classification in general, and the question of whether a foreign partnership would be respected as a partnership for Canadian tax purposes in particular, followed predictable general principles that were perhaps also not very definitive.

In the 2001 decision in *Backman v. Canada*,³ the Supreme Court of Canada considered the status of a Texas limited partnership for Canadian tax purposes. Not surprisingly, the Court stated that when determining the status of a foreign partnership for Canadian tax purposes, the essential elements of a partnership under Canadian law must be present.⁴ It found the key elements for this purpose to be the following:

- (a) there must be a business,
- (b) carried on in common, and
- (c) with a view to profit.⁵

As suggested, these factors, while hardly surprising, may well not be sufficient to serve as a clear marker for purposes of delineating the differences between partnerships and other forms of business association that may share similar attributes. In *Backman*, these factors were sufficient to enable the Court to rule against the taxpayer, as the Court found that the relevant taxpayers lacked the intent to carry on business in common with a view to profit.⁶

As recently as 2014, the CRA commented on *Backman* in a CRA interpretation where the question was whether an LLLP formed under U.S. state law should be treated as a partnership, a corporation, or some other entity for Canadian tax purposes.⁷ While the CRA declined to offer a real interpretation at that time and opted to defer until a specific advance income tax ruling might be submitted, the CRA outlined the following approach to foreign "entity" classification:

The CRA's approach to entity classification is a two-step approach. That is, to determine the status of an entity for Canadian tax purposes, we would:

- 1) Examine the characteristics of the foreign business association under foreign commercial law and any other relevant documents, such as the partnership agreement or other contracts; and

³ *Backman v. Canada*, 2001 SCC 10 (Can).

⁴ *Id.* ¶ 17.

⁵ *Id.* at note 3, ¶ 18.

⁶ *Id.* at note 3.

⁷ CRA Technical Interpretation, 2014-0523041C6 (June 16, 2014).

2) Compare these characteristics with those of recognized categories of business associations under Canadian commercial law in order to classify the foreign business association under one of those categories.⁸

Again, none of that appears particularly surprising, but also not particularly definitive. It is within this general context that CRA's more recent position with respect to U.S. LLPs and LLLPs can be considered.

RELEVANT FEATURES OF U.S. LLPs AND LLLPs

As Canadian tax attorneys, our ability to speak to the inherent features of U.S. LLPs and LLLPs is necessarily limited, but while much has been written on the topic, one could do worse than to cite excerpts from the following Missouri Secretary of State Small Business Start-up Guide to illustrate general attributes of such entities:

(4) Limited Liability Partnership

In order to create a liability shield for all partners one may chose to form a limited liability partnership or LLP. Once a partnership is registered as a limited liability partnership, no partner is liable or accountable in any manner for the debts, obligations or liabilities of the partnership. There is an exception to this limited liability rule, however, as a partner is liable for his own negligent or wrongful acts or misconduct. This liability shield for all partners in a limited liability partnership is the only significant difference between a general partnership and a limited liability partnership, and provides a partnership with the same liability protections found in a corporation without the need to adhere to corporate formalities or suffer corporate taxation.

To secure limited liability partnership classification, a partnership files an application with the Secretary of State.

...

(5) Limited Liability Limited Partnership

Just as a general partnership can register as a limited liability partnership, thus affording all of its partners a liability shield, a limited partnership can elect to register as a limited liability limited partnership or LLLP. This registration gives all of the partners in the limited

⁸ *Id.*

partnership, including the general partners, protection from personal liability for the debts, obligations or liabilities of the partnership.

The partners in an LLLP do have liability exposure for their own negligence, wrongful acts or omissions, just as the partners in an LLP. In short, partners in an LLLP have the same liability shield as those in an LLP; in fact, the Missouri law that establishes the LLLP liability shield directly states partners in an LLLP have the limitation on liability afforded to partners of an LLP under the LLP statutes.

As in an LLP, other than the limited liability afforded to all partners, an LLLP is the same limited partnership as it was before registration. The same rules for registration as an LLP apply for registration as an LLLP.⁹

As noted in this excerpt, while LLP registration is meant to confer limited liability on partners of what would otherwise be a general partnership, and LLLP registration is meant to confer limited liability on partners (including the general partner) that would otherwise be subject to the rules governing limited partnerships, both LLP and LLLP status derive from an “add-on” registration that otherwise leaves the underlying partnership structure intact.

It follows that none of this overlay is likely to have any impact on the key elements identified by the Supreme Court of Canada in *Backman* as relevant to partnership characterization, namely the intent to carry on business in common with a view to profit.

POSITION OF THE CRA

In its position stated at the May 2016 IFA Roundtable, the CRA was fairly candid in setting out its reasoning in concluding that Florida and Delaware LLPs and LLLPs should be treated as corporations for Canadian tax purposes:

We are now ready to take a final position. We will reiterate a couple of the factors that we considered to be of overwhelming significance - those being:

- **legal personality** - I know we went down that road a number of years ago, but these entities that we were asked

⁹ Missouri Small Business Startup Guide, *Limited Liability Limited Partnership* (Aug. 16, 2016, 2:10pm), available at http://www.sos.mo.gov/business/outreach/startup_guide.

to opine on [i.e. LLPs and LLLPs] were substantively different, in that;

- in addition to having legal personality (which admittedly is a slightly vague concept), they have **limited liability protection** (and I don't find that to be a very vague concept – that is what corporations have).

So, despite whatever arguments may exist that these entities operate as partnerships, we think that, similar to LLCs, these entities are corporations. So, just to be clear: we have reached the general conclusion that Florida and Delaware LLPs and LLLPs should be treated as corporations for the purpose of Canadian income tax law.¹⁰

While the stated position was limited to Florida and Delaware LLPs and LLLPs, there is no substantive reason to think the CRA's approach would be different for corresponding partnerships formed under the laws of other states.

In referencing the relevance of an LLP or LLLP having “legal personality,” we submit that the CRA is making too much of a theoretical issue that appears to have lost relevance even under U.S. commercial law, and to that extent, the CRA is not consistently applying its own guidelines of approaching foreign-entity characterization from the perspective of honoring the characteristics of the business association under foreign commercial law. The issue was summarized as follows in a recent NYU School of Law Tax Policy Colloquium:

In researching the issue, it soon became clear that virtually every type of U.S. entity that exists today, including a simple general partnership, probably has what many other countries would view as legal personality. Not only is the construct of legal personality completely foreign to U.S. tax classification rules; the construct barely survives as a matter of U.S. commercial law. Already by the year 1928, papers presented at a legal symposium in Chicago on the subject of business entities illustrated that the concept was beginning to lose its meaning. Over time, the conceit that in order to be a partnership for U.S. commercial law purposes, an entity must lack legal personality, was abandoned as a quaint artifact of an earlier age.¹¹

¹⁰ *Id.* at note 1.

¹¹ Kimberly Blanchard, NYU Law School, Tax Policy and Public Finance Colloquium and Seminar, *The Tax Significance of Legal Personality: A U.S. View* (2015).

The CRA emphasis on limited liability protection, in contrast, probably has more relevance, though it may be asked (i) how substantive a point of differentiation this really is, considering that most forms of U.S. business associations can achieve very similar levels of liability limitation,¹² and (ii) why this should be seized on as such an important factor for foreign entity classification given that Canadian provinces have their own LLP legislation (substantively similar to relevant U.S. state comparables) but in a domestic context the CRA is quite willing to honor the stated intent of LLP partners that the LLP is a partnership.

The point certainly could be made, and has been made,¹³ that these factors are simply not sufficient to outweigh the fundamental characteristics of a partnership as a relationship (among members carrying on business in common with a view to profit), and one that is based on a contract among the partners, as opposed to a corporation's fundamental characteristic of having been constituted as a creature of statute. However, unless and until the CRA changes its approach or a court of law determines the issue, taxpayers will have to deal with the practical reality of the CRA's new interpretative approach.

IMPACT ON CROSS-BORDER STRUCTURES

Previously, Canadian residents reported their interests in LLPs or LLLPs as U.S. partnership interests; therefore, business income from such LLPs or LLLPs flowed through to Canadian residents as their own taxable income for Canadian tax purposes, and a corresponding Canadian foreign tax credit could generally be claimed by the Canadian residents in respect of U.S. taxes paid on the income allocated by the LLPs or LLLPs.

Under CRA's new position, it follows that income of an LLP or LLLP is considered to be business income of the U.S. "corporation," and while Canadian investors will continue to be allocated income by the partnership and be subject to U.S. taxation, the ability to claim a Canadian foreign tax credit (or deduction) will be suspect. Canadian investors are now faced with additional complications and potential double taxation on investments in LLPs and LLLPs because of the differences in timing of income and taxation as between Canada (which should now tax at the time distributions are made by the LLP or LLLP) and the United States (which is understood to tax when income is allocated annually by the LLP or LLLP). The benefits of investing through an LLP and LLLP are effectively diminished due to the cross-border tax inefficiencies arising out of CRA's new approach.

¹² See *id.*, at 11, where the author notes: "What do owners achieve by using a Delaware LLP rather than an LLC?...the larger point here is that the U.S. tax law, having seen the writing on the wall, has abandoned any conceit that limited liability matters to entity classification for tax purposes, given the reality that almost any type of U.S. entity can today afford almost complete protection from liability."

¹³ Joel Nitikman, Tax Topics, *Is an LLP a Corporation for Canadian Tax Purposes? A Reply to CRA*, 2313, Tax Topics (Wolters Kluwer), Jul. 2016, at 1.

Furthermore, it is unclear how CRA intends to reconcile the situation where income has already been reported as partnership allocations by existing Canadian resident investors of LLPs or LLLPs, particularly in instances where actual distributions are deferred for years following the year of allocation, and the conditions set out for administrative relief are not met.

CRA ADMINISTRATIVE RELIEF AND RESIDUAL ISSUES

The CRA recognizes that its new approach to LLPs and LLLPs may have broadly negative impact, and has set out a degree of administrative relief for certain LLPs and LLLPs that are prepared to convert to another “entity” (basically, a general partnership or limited partnership) before 2018:

[The CRA] acknowledge[s] the difficulties that might be created by these positions. In order to promote fairness and predictability, we are prepared to make certain administrative concessions. Specifically, in the absence of abusive tax avoidance, we are prepared to accept that any such previously created LLP or LLLP be treated as a partnership for the purposes of the Act from the time of its formation where four conditions are satisfied:

- the entity is formed and begins to carry on business before July 2016;
- it is clear from the surrounding facts and circumstances that:
 - the members are carrying on business in common with view to a profit (the general condition for partnerships); and
 - they intended to establish an entity that would be treated for Canadian income tax purposes as a partnership and not a corporation;
- 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
- finally (and most importantly) the entity has to convert to an entity that we will recognize as a partnership, for example a general partnership or a limited partnership, before 2018.

We are going to give some administrative relief where those conditions are met, and they will be retroactive, so that we will allow partnership treatment for these entities

back to day one, if these conditions are met, the key one being that they convert before 2018. However, if the entity starts off as an LLC, a C Corp or in some other well understood corporate form, and then converts to an LLP or a LLLP (so if an LLC, for example, has converted to an LLP or an LLLP) and there is no significant substantive change to the legal context, we will not offer this administrative relief.¹⁴

As welcome as this administrative relief obviously is, it leaves clear gaps, including the scenario where a Canadian minority partner is simply not in a position to convince a larger U.S. LLP or LLLP to effect such a conversion. While more detailed grandfathering proposals may be expected, it seems unlikely they would address this point unless the CRA has a significant change in approach in the interim.

A further question is whether the conversion itself would create its own tax problems. While it is understood that a conversion from an LLP or LLLP into an LP is likely a reasonably straightforward transaction from a U.S. tax perspective and unlikely to trigger a taxable event, the situation in Canada may be less clear. If CRA now considers an LLP or LLLP to be akin to a corporation, it may be instructive to consider situations where previous conversions from corporate to partnership status have been considered. For example, in a 2004 interpretation commenting on a conversion of a Delaware LLC to a limited partnership, the CRA concluded that because the entities are treated differently for Canadian tax purposes, the conversion would be considered to trigger a disposition of the “shares” of the LLC by its holders and a disposition of the property of the LLC itself.¹⁵

However, it is reasonable to hope that the CRA would not offer administrative relief without also permitting the conversion event itself to proceed without triggering a tax event. Indeed, this seems apparent within the form of CRA’s announcement, as the intended grandfathering would treat the relevant LLP or LLLP (once it has complied with the CRA requirements and has converted) as a partnership retroactive to the time of its formation, such that comparisons to other corporation-to-partnership conversions do not appear to be relevant.

CONCLUSION

While CRA’s new interpretative approach is certainly open to debate, until a Court of law determines otherwise, Canadian taxpayers have to deal with the practical issues of conducting themselves subject to the new policy. Conversion into a conventional limited partnership is likely to be the best approach in those cases where it is commercially

¹⁴ *Id.* at note 1.

¹⁵ CRA Technical Interpretation, 2004-0104691E5 (Aug. 14, 2008).

feasible. In addition, more guidance from the CRA would be welcome, and any Canadian-resident investor in an LLP or LLLP should follow future CRA pronouncements carefully and consult with appropriate tax advisors with respect to the steps that may best be taken to mitigate the investor's exposure to tax inefficiencies.