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Canada's Enhanced Transitional Rules for U.S. LLPs and LLLPs

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INTRODUCTION

This article provides updates about the Canada Revenue Agency's May 26, 2016, non-binding administrative decision to treat certain U.S. limited liability partnerships (LLPs) and limited liability limited partnerships (LLLPs) as corporations and reports on an announcement this past April to substantially liberalize the transitional rules for pre-existing LLPs/LLLPs.

There was a time when tax law in Canada and the United States treated all entities formed under partnership law in Canada and the United States as entities that are not separate taxpayers but rather are pass-throughs or transparent in the sense that it is their owners (individuals, corporations, trusts or estates) who report and pay tax on the income earned by such entities or claim the losses sustained by them. But, then, departures from that monolithic situation materialized.

First, the U.S. courts and the Internal Revenue Service started treating certain partnerships as corporations[2] and then in 1996, the United States adopted specific law that allowed election of such treatment.

Second, in 2000, as a result of Delaware statutory partnership law adopting separate legal personality for partnerships, the Canada Revenue Agency (''CRA'') started threatening to tax such partnerships as corporations — but ultimately did not.[3]

Third — and the genesis of this commentary — in May 2016, the CRA announced at a seminar of the Canadian branch of the International Fiscal Association (IFA) that it had concluded, after an in-depth study, that Delaware and Florida LLPs and LLLPs should be treated as corporations for Canadian tax purposes, whether used by U.S. persons to invest or carry on business in Canada or by Canadians to invest or carry on business in the United States. And it was pretty clear that the same view would be adopted for similar entities formed under the laws of other states (see note 4 below).[4]

The full background and nature and implications of the foregoing — including the transitional rules that the CRA adopted for pre-existing LLPs and LLLPs — was canvassed in a report in the August 2016 issue of Tax Management International Journal.[5]

This article provides an update to that report, following a statement the CRA made April 26, at this year's annual seminar of the Canadian IFA branch in Toronto. The CRA announced important changes to the transitional rules for pre-existing LLPs and LLLPs, allowing any such entity formed before April

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[2] More than 50 years ago, the U.S. adopted the view (through regulations based on case law) that any business entity having three or more of the four key ''corporate'' characteristics should be treated as a corporation (rather than a partnership) for U.S. tax purposes.

[3] Amended Delaware Revised Uniform Partnership Act (DRUPA), effective in 2001 6 Del. Code, c. 15. §15-201 DRUPA reads: ''Partnership as entity. (a) A partnership is a separate legal entity which is an entity distinct from its partners unless otherwise provided in a statement of partnership existence or a statement of qualification and in a partnership agreement.'' *See* Income Tax Technical News, No. 20 (June 14, 2001). Income Tax Technical News, No. 25 (Oct. 30, 2002). Technical Interpretation 2004-0104691E5 ''Conversion of a limited liability corporation to a limited partnership (Aug. 14, 2008). Nathan Boidman, *Revenue Canada Threatens to Treat Delaware Partnerships as Corporations*, 29 Tax Mgmt. Int'l J. 583–584 (Oct. 13, 2000); and Nathan Boidman, *Revenue Canada Reverses Position on DRUPA*, 30 Tax Mgmt. Int'l J. 36 (Jan. 12, 2001).

[4] It should be noted that CRA positions and views and interpretation do not make law per se.

[5] *See* Nathan Boidman, Esq., Peter Glicklich, Esq., and Michael Kandev, Esq., *Canada's New Approach to U.S. LLPs and LLLPs*, 45 Tax Mgmt. Int'l J. 479 (Aug. 12, 2016).

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26, 2017, to file as a partnership for all prior and future tax years, provided that certain specified conditions did not apply.

BRIEF REVIEW OF 2016 INITIATIVE AND BACKGROUND THERETO

The basic position adopted by CRA in 2016 was to treat an LLP/LLLP as a corporation if (1) the entity has a legal personality, and (2) no partner is liable for the obligations of the partnership.[6]

That would render inapplicable the partnership rules under which, for example, a U.S. person that is a member of a partnership that is carrying on business in Canada, will be the taxpayer in Canada in respect of the income earned by the partnership in Canada.[7] And it would render inapplicable such flow-through treatment in Canada for Canadians using such entities for U.S. investment.

There is no definition of partnership for section 96 treatment nor is there a fulsome definition of corporation.[8] In light of this ''thin'' legislation, the courts have established that the character accorded a foreign entity be that which most closely resembles that of a Canadian entity. Therefore, Canada has had no trouble in characterizing U.S. LLCs as corporations.

On May 26, 2016, the CRA announced that, in light of their resemblance to Canadian corporations, such LLPs and LLLPs also would be treated as corporations for Canadian tax purposes for all open periods, even retrospectively, subject to limited grandfathering protection. In its explanation, the CRA focused two factors: one is the entity's separate legal personality, and the other is the exclusion of *all* partners from liability for the obligations of the partnership.[9]

THE 2016 TRANSITIONAL RULES

In 2016, CRA said its new view would be applied retroactively by CRA to all open years of a relevant taxpayer unless the partners of such a partnership have already filed tax returns in Canada reflecting the entity as a flow-through and, even then, the entity must be converted into either a GP or LP before 2018. As well, the entity must never have been an LLC.[10]

The August 2016 commentary well identified a number of difficulties that could arise (inbound or outbound) from converting tax status (from partnership to corporation) or by converting legal status (from LLP/LLLP to GP or LP) in order to *not* change tax status. But it also noted some potential benefits. Overall, however, the 2016 transitional rules were troublesome, making this year's development very welcome.

THE NEW (2017) TRANSITIONAL RULES

In November of last year, CRA said, at the Annual Conference of the Canadian Tax Foundation, that taxpayer concerns about the transitional rules had led to a review that was still in progress. At that point, the focus was on eliminating the retroactivity and was put forward as follows:

> The CRA has established an internal working group to study compliance issues related to LLPs and LLLPs. It is being led by members of the audit branch, specifically the International Tax Division (''ITD'') of the International and Large Business Directorate of the International, Large Business and Investigations Branch. Some questions and submissions have already been received by officials of the CRA and have been brought to the attention of members of the working group. The ITD is open to a prospective approach whereby prior filings would, in certain circumstances, be allowed to stand, and welcomes submissions from taxpayers and their representatives in this regard. Submissions should be sent by February 28, 2017, to the following mailbox: DELAWAREFLG@cra-arc.gc.ca. CRA Views 2016-0669751C6: 2016 CTF — Q10 — U.S. LLPs and LLLPs — Section 150

Then on April 26, CRA announced a major change: to allow pre-existing LLPs/LLLPs to continue to file for the future as partnerships. CRA put the matter as follows:

> After an analysis of the complexities for taxpayers and the tax administration of transitioning from partnership filings to corporate filings, the CRA has decided to build on the prospective approach referred to in the November 2016 CTF announcement by offering administrative grandfathering. In particular,

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[6] This treatment, confirmed in a July 20, 2016, written statement, CRA Views, 2016-0642051C6, ''IFA 2016 Q.1: Classification of U.S. LLPs & LLLPs — Section 248(1) 'corporation' '' (July 20, 2016), was articulated by CRA to be applicable to such entities formed under the laws of Delaware and Florida but was expected to be applicable to those formed under the laws of many, if not all, other states.

[7] *See* section 96 of the Income Tax Act (Canada), R.S.C. 1985 c. 1 (5th Sup.) (the ''Act'').

[8] Subsection 248(1) defines ''corporation'' to include an incorporated company.

[9] Note that the August 2016 commentary (Note 4) questioned this (at page 481): ''Is this view necessarily correct? Arguably not: 'Florida LLPs and LLLPs are formed, exist and dissolve by virtue of the contractual arrangements between two or more persons instead of being legal persons formed and dissolved only by state action.' See Michael N. Kandev and Sandra Slaats, *Recent Developments in the Foreign Affiliate Area*, Report of Proceedings of the Sixty-Seventh Tax Conference, 2015 Conference Report (Toronto: Canadian Tax Foundation, 30:1). This observation would deny the correctness of the CRA's conclusion.''

[10] These details were announced at the May 26 IFA seminar — see above.

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the CRA will be adopting the administrative practice of allowing any such entity formed before April 26, 2017, to file as a partnership for all prior and future tax years, provided none of the following conditions applies:

- One or more members of the entity and/or the entity itself take inconsistent positions from one taxation year to another, or for the same taxation year, between partnership and corporate treatment;
- There is a significant change in the membership and/or the activities of the entity; or
- The entity is being used to facilitate abusive tax avoidance.

Unfortunately CRA provided no guarantees respecting the second condition. The release went on to say that where any of the conditions are met, ''the CRA may issue assessments to the members and/or the entity, for one or more taxation years, on the basis that the entity is a corporation.'' Again, the word ''may'' is not explained.

With respect to the April 26 cut-off, the release says:

> For these purposes, the CRA will consider any such entity to have been formed on the day on which the appropriate governmental organization accepts the filing of the required documentation in respect of the establishment of the entity as an LLP or LLLP, as the case may be.

CRA notes that, of course, any such entity that has consistently filed as a corporation for Canadian income tax purposes may continue to file on that basis.[11]

Finally, the release confirms that LLPs and LLLPs formed after April 25, 2017 will be treated as corporations, and that LLPs or LLLPs of other states having similar attributes to those of Florida and Delaware will be subject to these CRA views and guidelines.

CRA's final comment is worth noting:

> The CRA is of the view that Article IV(6) of the Canada-U.S. tax treaty will apply to any such LLPs or LLLPs that are treated as nonresident corporations for Canadian tax purposes and as fiscally transparent entities for U.S. tax purposes. As such, the CRA generally intends to administer that provision vis-à-vis relevant LLPs and LLLPs in a manner similar to its published practices in respect of U.S. limited liability companies.

That means, for example, that if an LLP earns dividends from Canadian corporations, the portion attributable to qualified U.S. treaty residents will be eligible for the benefits of Article X of the treaty.

CONCLUDING COMMENT

The initial announcement, in May 2016, that the CRA would treat LLPs and LLLPs as corporations was somewhat shocking but by no means a total surprise. But the absence of full grandfathering for preexisting entities was both unexpected and seen by observers as unfair given the uncertainty of the law governing the issue.

That glaring deficiency in the initial announcement has now been largely redressed by the statement of April 26, 2017, and should provide those who utilized such entities on the understanding they would be treated, in accordance with long-established tax law practice as partnerships, with the basis to not be subject to the various issues of converting status that were canvassed in the August 2016 report.

Those who in the future use such entities know the CRA will treat them as corporations. Whether they would then challenge that position and the outcome of such challenge is a matter that will be of interest should it arise.

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[11] In this context, the release says:

> Any such entities that choose to file as corporations notwithstanding the administrative grandfathering relief will be expected to do so for all open taxation years in which the entity has existed, including filing initial corporate tax returns for past years, as necessary. In this regard, previously filed tax returns of entity members may require adjustment in order to eliminate double-counting of income or losses.

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