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Changes in the treatment of U.S. LLPs and LLLPs

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The Canada Revenue Agency's (CRA) recent change to its position on the classification of two popular entities for U.S. real estate investing has thrown a wrench into tax structure planning for Canadian investors.

Until recently, U.S. limited liability partnerships (LLPs) and limited liability limited partnerships (LLLPs) were attractive options for Canadians investing in U.S. real estate. These U.S. state-governed entities provide liability protection to investors while still allowing for the flow-through treatment of income directly to their partners.

On May 26, 2016, at the 2016 International Fiscal Association Conference CRA Roundtable, the CRA announced its long-anticipated conclusion to the analysis of the appropriate classification of LLPs and LLLPs governed by the state laws of Florida and Delaware.[1] In what was a shock to many tax practitioners and taxpayers, the CRA concluded that these two types of entities share more of a likeness with Canadian corporations than they do with Canadian partnerships.

Furthermore, the CRA also indicated that similar structures governed by other states would be analyzed by a similar standard in determining appropriate classification for Canadian purposes. While they have not yet addressed other states, it would seem reasonable to conclude that any investment structures using U.S. LLPs or LLLPs should be viewed with caution from a Canadian investor perspective, and alternate structures should be considered for future planning purposes.

At issue is the symmetry of income recognition and the application of foreign tax credits. Prior to this announcement, conventional treatment of these two types of entities had leaned towards Canadian tax treatment as a partnership. In the U.S., both LLPs and LLLPs are transparent, with income and losses flowing directly to their partners for tax purposes; the entities themselves did not pay tax. Classifying an entity as a partnership in Canada allowed for the recognition of profits and losses by the same inherent entity and in the same period for Canadian tax purposes (i.e., each partner would recognize the income or losses in the same fiscal year in Canada as they did in the U.S.). This same-entity taxation of profits also allowed for alignment of the tax itself. In order for the taxpayer to claim foreign tax credits (FTCs) in Canada for the tax paid on that income in the U.S. (and thereby avoid double taxation), the tax had to have been paid by the same entity as that claiming the FTC.

This symmetry of treatment in both countries made U.S. LLPs and LLLPs popular vehicles for Canadians investing in U.S. real estate, while also providing some level of protection against liability. As a result, a significant number of these structures have been set up in the past based on this assumption that Canadian tax treatment would mirror the flow-through treatment in the U.S. The recent and unwelcome conclusion by the CRA that these entities are more appropriately treated as corporations for Canadian tax purposes has disrupted future tax planning for these structures, and has raised the question of what to do about the existing ones.

Under the new classification, Canadian investors may be subject to the loss of the symmetry in the timing of revenue recognition, as well as the potential loss of FTCs due to the mismatch in the taxable entity. As with the tax issues associated with Canadians owning interests in U.S. limited liability companies (LLCs), additional care would be required to ensure distributions are similar in both time and period to the income earned. While

1 26 May 2016 IFA Roundtable Q. 1, 2016-0642051C6 - Classification of U.S. LLPs & LLLPs.

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this is a viable option for entities in which the client has some measure of control over the timing and amount of distributions, investors with smaller proportionate holdings may not have that ability to influence distributions, and thus will be exposed to double taxation. This is a significant issue for many Canadian investors with these structures.

Although the CRA has not yet released its written conclusion or provided other written guidance, it has indicated orally that it will provide administrative relief in the form of a limited grandfathering for certain existing structures. While this step is intended to relieve some of the immediate burden of what the CRA clearly recognizes is an unwelcome decision, it provides only limited relief. Specifically, the CRA has said it will allow existing LLPs and LLLPs to continue treatment as partnerships for Canadian purposes for the immediate future where:

1. the LLP or LLLP was formed before July 2016 and carried on business before that time;
2. the taxpayers intended the LLP or LLLP to be classified as a partnership for Canadian tax purposes;
3. the LLP or LLLP and each of its owners has treated the entity as a partnership for Canadian tax purposes; and
4. the LLP or LLLP converts to an entity that the CRA recognizes as a partnership no later than 2018.

Although the administrative relief is welcome, Canadian investors are unlikely to embrace these changes whole-heartedly. The additional liability protection given to LLPs and LLLPs, while still allowing treatment as a flow-through for tax purposes, was a part of the attraction of these entities. In situations where this protection is a priority, there may be other options for Canadian investors to consider that would mitigate liability going forward.

As well, there is the question of the tax implications of the application of the grandfathering relief. Care must be taken to ensure that a taxable disposition is not triggered on a conversion. For instance, while it is a fairly simple matter to convert a U.S. LLP or LLLP to an LP (Limited Partnership), doing so would trigger a taxable disposition for Canadian purposes. Existing rollover provisions for partnerships may be available, but these transactions must take place before the relief period runs out in 2018. Again, the same issue for the minority investor exists, where they may not have the influence required to enforce a conversion from LLP or LLLP to LP.

If you have a U.S. LLP or LLLP, or would like to discuss other options for investing in U.S. real estate, contact your Collins Barrow tax advisor for more information.

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