If it quacks like a Partnership, it is a… Corporation?

Moodys Private Client
June 1, 2015

At the Canada Revenue Agency ("CRA") Roundtable session during the International Fiscal Association Conference on May 28, 2015, the CRA was once again asked to comment on the issue of foreign entity classification. In contrast to the CRA's usual response of merely reaffirming the use of the "two-step" approach, the CRA revealed several surprising insights about their views. The CRA indicated that they are currently analyzing entity classification for Florida and Delaware Limited Liability Limited Partnerships ("LLLPs") as well as Florida Limited Liability Partnerships ("LLPs"), none of which have previously been the subject of specific determination by the CRA with respect to their classification. The CRA also confirmed that they are accepting submissions in respect of the classification of these entities. Another unexpected revelation was when the CRA representative mentioned that they are considering a request from a taxpayer wanting to take the position that a US Limited Liability Company ("LLC") is a partnership. It is the CRA's longstanding position that LLCs are corporations for Canadian income tax purposes, so the fact that the CRA may be considering otherwise was surprising indeed.

The CRA indicated that their LLLP and LLP analysis is very focused on the exact nature of the limitation of liability afforded to members of these entities. According to their preliminary finding, the extent of liability protection provided by LLLPs and LLPs to their members, including the general partners, seems to be beyond the limitation of liability found in Canadian partnerships. The CRA also commented that these LLLPs and LLPs have elements of legal personality – meaning they can own property in their own right, and have the right to sue and be sued in their own name, among other attributes. Additionally, the CRA pointed out that under some state laws a partnership can be converted to a LLC or a regular corporation without effecting any change in the ownership of its assets, and that this also is an area of concern for the CRA.

Effectively, while the CRA acknowledged aspects of US LLLPs and LLPs that make them similar to Canadian partnerships, the presence of legal personality and broad limited liability for all members is potentially leading the CRA towards classifying these entities as foreign corporations.

As part of their response, the CRA reconfirmed their commitment to the two-step approach to foreign entity classification, and emphasized in particular that one should not simply consider any entity with legal personality to be a corporation. The two-step approach to foreign entity classification, originally set out in CRA Income Tax Technical News, ITTN-38, is to:

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
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.

The CRA emphasized in ITTN-38 that the most important attributes to be considered are the nature of the relationship between the various parties, and the rights and obligations of the parties under the

applicable laws and agreements.

This two-step approach to entity classification is consistent with the approach taken by Canadian courts, for example in *Continental Bank of Canada v. The Queen*[1] and in *Backman v. R.*[2], so while it may be possible to argue with this methodology from a policy perspective, it is a valid approach grounded in jurisprudence.

What is a Partnership?

The Canadian Income Tax Act (the "Act") does not define the term "partnership". The term "Canadian partnership" is defined in subsection 102(1) of the Act as "*a partnership all of the members of which were, at any time in respect of which the expression is relevant, resident in Canada*". Unfortunately this circular definition is not particularly helpful with respect to the classification of a foreign entity. Fortunately, there are a number of elements which have been identified both by the courts and by the CRA in their published administrative positions which help us define what is an otherwise undefined term under the Act.

According to the CRA's archived Interpretation Bulletin *IT-90 What is a partnership?*, a partnership is the relationship that subsists between persons carrying on business in common with a view to profit. This view is consistent with the provincial statutes governing partnerships. For example, in section 2 of the Ontario Partnership Act, a partnership is defined as "*the relation that subsists between persons carrying on a business in common with a view to profit* [unless the relationship is incorporated or registered as a corporation]".

In *Continental*, the Supreme Court of Canada has adopted the criteria in the Ontario statute as the primary consideration in the determination of whether a partnership exists for tax purposes. These criteria were also used in other cases, for example *Backman*, and *Spire Freezers Ltd. v. R.*[3]

As such, the three essential ingredients required to be a partnership are:

1. Carrying on a business;
2. In common between two or more persons; and
3. With a view to a profit.[4]

The Supreme Court of Canada also pointed out in paragraph 17 of *Backman* that, for the purposes of the Act, the essential elements of a partnership are the same irrespective of whether the entity in question is a domestic or foreign partnership.

So what is an LLLP?

With this framework in mind, should a US LLLP be treated as a corporation as the CRA's preliminary comments seem to indicate? For sake of illustration, we will focus our discussion on Florida LLLPs.

The courts have provided ample guidance with respect to the meaning of each essential ingredient of a partnership, and it should be a simple question of fact whether a particular LLLP meets these requirements. A Florida LLLP is first and foremost a limited partnership ("LP"), albeit one that has

received the special designation of a limited liability limited partnership.[5] A partnership under Florida partnership law is formed by two or more persons carrying on a business together for profit with an agreement between the partners to govern the relationship between the parties.[6]

Therefore, by its nature, a Florida LLLP includes the three essential ingredients identified by the Canadian courts as being required for a partnership. However, in addition to these three essential ingredients, there are other characteristics which have been identified by past court decisions and CRA published administrative positions, and it appears to be these characteristics on which the CRA is focusing.

Personality and Liability

The requirement that a partnership should not have a distinct legal personality, or limits in respect of the liability of its members, has been identified by the courts previously. For example, the Federal Court of Appeal in *Adams v. The Queen* pointed out in paragraph 11:

> "It is well accepted that at common law a partnership does not constitute a distinct legal person such that it is separate from its members. Indeed, it is the lack of a separate legal personality and limited liability that distinguishes a partnership from a corporation. In this regard, the Income Tax Act recognizes the lack of legal personality of a partnership by not treating "it" as a taxpayer. Admittedly, a partnership must file an annual information return setting out the income of the partnership, but it is the individual partners who are liable to pay tax on the partnership's income. For taxation purposes, the partnership is treated as a "separate person resident in Canada" solely for the purpose of calculating income at the partnership level. In this way each partner's share of the income may be allocated accordingly: see paragraph 96(1)(a.)."[7]

The Federal Court of Appeal in *Madsen v. R*[8] also addressed the lack of separate legal personality as being a characteristic of a partnership. The Court stated in paragraph 16: "*A partnership's lack of separate legal personality is what distinguishes it from an individual or corporation…*"

Distinct Legal Personality

Subsection 620.1104 of Florida Partnership Law effectively treats an LLLP (note that in this context the statute uses the term LP interchangeably with LLLP) as an entity distinct from its partners. It is therefore conceivable that a LLLP differs from the Canadian view of a partnership in this respect.

> 620.1104 Nature, purpose, and duration of entity. –
>
> (1) A limited partnership is an entity distinct from its partners. A limited partnership is the same entity regardless of whether its certificate states that the limited partnership is a limited liability limited partnership…

While this certainly appears to sway the argument towards the presence of a distinct legal personality, some of the LLLP agreements our clients bring to us include clauses that state that if one of the partners of the LLLP dies or becomes incapacitated, the partnership is terminated and/or dissolved. Where this clause exists, it suggests that in fact a LLLP's legal personality is not separate from that of its partners, in as much as if one of the partners dies, so too does the partnership.

Additionally, it seems that the separate legal entity concept does not extend to governance and actual operation. As set out in Florida statute 620.1403, and similar to what we are familiar with in Canadian

limited partnerships, a general partner of a LLLP in effect governs the partnership. From a Canadian corporate law perspective, the legal personality of a corporation means that the management of the corporation is the responsibility of an elected board of directors, so the LLLP governance model is not consistent with that of a Canadian corporation.

Regardless, consistent with the CRA's response at the Roundtable, the CRA has previously opined that a separate legal entity clause in foreign partnership legislation should not, in and of itself, preclude an entity from being a partnership for purposes of the Act. An example of this is a partnership constituted under the *Delaware Revised Uniform Partnership Act* and the *Delaware Revised Uniform Limited Partnership Act*. The CRA showed that a partnership under these Delaware legislative provisions was a separate legal entity distinct from its members (subject to the partnership agreement providing otherwise). However, the CRA stated in Income Tax Technical News, ITTN-34, and more recently in CRA document 2004-0104691E5[9], that an entity formed under these Delaware laws, in which members carry on business in common with a view to profit, more closely resemble those of a Canadian general partnership under Canadian common law, and therefore the entity would be treated as a partnership for Canadian income tax purposes.

Similarly, in CRA document 2006-020318117[10] the CRA found that the fact that an "association of persons" ("AOP") formed and carrying on business in Pakistan may be treated as a separate person pursuant toPakistan law was not determinative of whether or not the AOP would be treated as a partnership or a corporation, and in this case, the CRA in fact concluded that an AOP was a partnership.

Liability

Pursuant to Florida statutes 620.1404(3), partners of a LLLP are prevented from being liable for the obligations of the partnership solely by reason of being a partner. This is, on the face of the matter, materially different from a Canadian partnership; however on closer examination it appears this may in fact be largely a difference of semantics. The language of the Ontario Partnership Act in subsection 10(2), with some exceptions, exempts an Ontario partner in a limited liability partnership from "*the debts, liabilities or obligations of the partnership or any partner arising from the negligent or wrongful acts or omissions that another partner or an employee, agent or representative of the partnership commits in the course of the partnership business while the partnership is a limited liability partnership; or (b) any other debts or obligations of the partnership that are incurred while the partnership is a limited liability partnership*".[11] Therefore, both Florida and Ontario partnership laws permit a form of partnership that limits the liability of all partners in some respect for the actions and liabilities of the partnership.

It is clear in practice that the presence or absence of unlimited liability is not a bright line test with respect to entity classification. For example, the CRA has found that there are a number of foreign entities that are corporations for purposes of the Act, despite the shareholders' unlimited liability for the debts of the firm. CRA document 9129645[12] finds a company where the shareholders have unlimited liability for the debts, but which was incorporated under the statues of a foreign jurisdiction, to be a corporation for purposes of the Act.[13] Similarly, despite the unlimited liability of shareholders for any liability, act or default of these firms, the CRA has also determined that Nova Scotia Unlimited Liability Companies and Alberta Unlimited Liability Corporations are corporations under the Act.[14] The classification of these entities as corporations despite their unlimited shareholder liability suggests that the degree to which the owners of a firm are, or are not, liable for the debts of a firm is not determinative with respect to entity classification.

Further to the matter of liability of a partner in a Canadian limited partnership, it is common commercial practice in Canada to set up a limited partnership with a corporate general partner that has no assets other than a nominal general partnership interest. In such arrangements, even though the general

partner is subject to joint liability with the limited partnership, the economic substance is such that the limited partnership solely bears all obligations by virtue of the general partner being merely an empty shell. From this perspective, it may fairly be said that there is no practical difference in economic substance between a Canadian limited partnership arrangement and a US LLLP.

Finally, with a LLLP the partners are allocated any profits or losses of the partnership, and the general partner, as an agent of the partnership, may bind the partnership. These factors are completely incompatible with a finding of corporation. In a corporation shareholders are not entitled to profits unless a dividend is declared by the corporation. Shareholders of a corporation cannot legally bind the corporation in their capacity as shareholders. Viewed from a tax perspective, a corporate entity would be subject to tax in its own hands, and for a partnership, its income is subject to tax in the hands of the partners. Under US tax law, an LLLP is a flow-through entity whereby the income is taxed in the hands of the partners, similar to the Canadian tax treatment for a partnership.

Based on the foregoing, it seems that many of the differences between a LLLP and a Canadian partnership in respect of partner liability are superficial.

Potential impact

The LLP is used primarily by professional services providers, like law and accounting firms, so any impact resulting from the classification analysis will likely be limited for Canadian taxpayers. This will not be the case with respect to the LLLP classification analysis. Implications to any Canadian resident taxpayers who invested in a LLLP assuming that it would be treated as a partnership may be far reaching and unwelcome; however the CRA's review should reduce the uncertainty surrounding the LLLP, and some modicum of certainty should be achieved going forward.

The classification of a LLLP as a corporation would, one presumes, result in Canada treating a LLLP like other US hybrids where corporate profits and losses are passed through to the shareholders, for example like a LLC or a US "S" corporation. While both an S corporation and a LLC are similar in as much as they are both a flow through entity, a S corporation is generally considered resident in the US for purposes of the Canada US Income Tax Treaty (the "Treaty"), whereas the current position of the CRA is that a LLC is not resident in the US for purposes of the Treaty, and hence does not receive Treaty benefits (after the Fifth Protocol, the Treaty effectively provides benefits to LLCs by deeming the members to have derived the income, but the LLC itself is still not considered a resident for purpose of the Treaty).

The rationale for denying treaty benefits to the LLC is that it is generally not subject to tax in the US and therefore it does not meet the requirements as stated in article IV(1), and the *Crown Forest* case, to be a resident of the US for the purposes of the Treaty.[15] With few exceptions, S corporation shareholders are required under US law to be US citizens or residents, which may be why this entity receives Treaty benefits. This residency requirement for S corporation shareholders means this is not an entity that most Canadian resident taxpayers will stumble into, and as such, our experience with S corporations is limited. In contrast, the LLC is widely used by Canadian investors, although the consequences, as our firm has previously discussed, of the LLC being regarded as a taxpayer not entitled to treaty benefits frequently results in double taxation and other negative tax outcomes.

If a LLLP is considered a foreign corporation for Canadian tax purposes, it may in many cases also be a foreign affiliate, or more importantly, a controlled foreign affiliate, depending on the level of Canadian

ownership. This distinction may make the LLLP a particularly poor choice for investment in real estate, or other passive investments, to which the foreign accrual property income ("FAPI") rules may apply. Although in most cases the income reported as FAPI will substantively mirror the partnership income allocation that has already been reported, US tax paid by a Canadian resident owner of an LLC, for example, is not considered to be foreign accrual tax in respect of the LLC, thus creating potentially negative tax consequences. The various challenges flowing from the mismatch of treatment in respect of Canadians investing in a US LLC have been thoroughly covered in other publications so we will not repeat them here.

Other practical challenges that a Canadian who has invested in a US LLLP will face if the CRA eventually lands on the determination that a US LLLP is a foreign corporation for Canadian tax purposes may include:

- Income that has been reported as partnership allocations pursuant to section 96, would instead have been required to be reported based on an actual distribution. For activities where taxable income is generally significantly less than cash flow (such as real estate rental), the income allocation reported by the Canadian investor may be significantly lower than the actual distribution causing the Canadian investor to have underreported income for Canadian tax purposes.
- A recent CRA ruling made in respect of US LLCs indicated that if the applicable State corporate laws and constating documents do not provide for stated capital akin to that which is provided for under Canadian domestic corporate law, a US LLC may not have any paid-up capital.[16] Applying the same rationale, if a LLLP is found to be a corporation, the CRA would likely also consider it not to have any paid-up capital. This would mean that no election could be made under subsection 90(3) for a distribution to be a tax free qualifying return of capital from the LLLP, and instead may be a taxable dividend from hybrid or taxable surplus.
- Where the activities of the members of a US LLLP are such that the LLLP is carrying on business in Canada, a LLLP found to be a corporation may have missed filing T2 income tax returns and paying the Canadian corporate income and branch taxes that would apply to a corporation.
- Potentially the Canadian partners will have missed filing T-1134 Information Returns Relating to Controlled and Not-Controlled Foreign Affiliates, or T-1135 Foreign Income Verification forms. Penalties may apply in respect of these missed filing obligations.
- The upstream loan rules in subsection 90(6) only apply to partnerships in as much as the creditor foreign affiliate is a member of the partnership. By treating a US LLLP as a foreign corporation, and thus a foreign affiliate, loans that would otherwise not be upstream loans may now be caught under these rules.

The potential impacts to Canadian taxpayers who have investments in US LLLPs are far reaching if the CRA finds a LLLP constitutes a foreign corporation for Canadian tax purposes. Currently there are approximately 27 states in the US that have LLLP enabling statutes, and while LLLPs represent a relatively new form of partnership, they are far from rare.

We have previously written about the uncertainty regarding the classification of a LLLP and, having recently submitted a ruling request to the CRA in respect of a US LLLP ourselves, we are keenly interested in CRA's eventual decision on this topic. It is often the case that changes to foreign legislation, or in this case the addition of new types of foreign entities, may create uncertainty for Canadian taxpayers. Therefore we applaud the CRA's decisive action to end this uncertainty, even though the potential consequences for certain Canadian investors involved with such vehicles may be extremely unpleasant.

[1] *Continental Bank Leasing Corporation v. The Queen*, 98 D.T.C. 6505 (S.C.C.). (hereinafter *Continental*).

[2]*Backman v. R.* [2001 D.T.C. 5149] (hereinafter *Backman*).
[3]*Spire Freezers Ltd. v. R.* [2001] D.T.C. 5158
[4]Note that these are basically the same as the US common law test with respect to the designation of an entity as a partnership. The US Supreme Court in Supreme Court in *Commissioner v. Tower*, 327 U.S. 280 set out the essential facts generally necessary to establish a partnership as follows: "A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses.
[5]Section 620.1102 of Chapter 620 Partnership Laws of the Florida Statutes.
[6]As provided for by the Florida Uniform Partnership Act Section 620.81001 Definitions.
[7]*Adams v. The Queen*, 1998 CarswellNat 385 (F.C.A.) [1998] F.C.J. No. 397, *The Queen v. Robinson*, 98 D.T.C. 6232, *Adams v. Canada*, 159 D.L.R. (4th) 205, [1998] 2 C.T.C. 333, *Minister of National Revenue v. Robinson*, 227 N.R. 63.
[8]Madsen v. R [2001 D.T.C. 5093].
[9]CRA document 2004-0104691E5 – Conversion of a limited liability corporation to a limited partnership, August 14, 2008.
[10]CRA document 2006-020318117 – Definition of "Corporation" in subsection 248(1), November 8, 2006.
[11]Paragraphs 10(2)(a) and (b) of the Ontario Partnership Act.
[12]CRA 9129645 – Meaning of "corporation", March 23, 1992.
[13]CRA document 9129645 – Meaning of "corporation" dated March 23, 1992.
[14]CRA document 2005-0141451E5 – Alberta unlimited liability corporations, dated March 15, 2006 confirms that an Alberta unlimited liability meets the definition in section 248 to be a corporation for purposes of the Act. Similarly document 9408195 – Corporate status of a Nova Scotia company (HAA 6363-1), dated June 27, 1994 confirms that a Nova Scotia Unlimited Liability Company is a corporation for purposes of the Act.
[15]*Crown Forest Industries Ltd. v. Canada*, [1995] 2 SCR 802.
[16]CRA document 2014-0535971E5 – Meaning of "paid-up capital" in subsection 90(3), March 20, 2015.