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The Canada – U.S. Tax Treaty: Treatment of U.S. LLCs

On September 21, 2007, representatives of the Canadian and American governments signed a long awaited protocol (the "**Protocol**") amending the income tax convention between these two countries (the "**Treaty**"). A much anticipated change involved the tax treatment of limited liability companies ("**LLCs**") established under the laws of the one of the states of the United States of America. LLCs are prevalent in the United States and are characterized by affording shareholders (referred to as "members") with the limited liability protection of a corporation while being flowthrough entities for United States income tax purposes (unless they elect to be treated as a corporation for tax purposes).

The popularity of LLCs with American resident investors has long caused problems for Canadian tax advisors when structuring investments in, or acquisitions of, Canadian businesses by LLCs. The reason for this problem was the Canada Revenue Agency's (the "**CRA**") position that LLCs were not residents of the United States for the purposes of the Treaty and, therefore, not entitled to its benefits. The rationale for this position was that an LLC was a corporation, and therefore a separate legal entity, which was not subject to tax in the United States. In order to be a resident of the United States for the purposes of the Treaty, a corporation must be subject to income tax in the United States based on its residency there. In addition, since the LLC was considered to be a corporation, the CRA would not look through it to examine the residency of its members, as it would with a partnership.

This CRA policy meant that, among other things, LLCs that owned shares of Canadian corporations would be subject to Canadian withholding tax on dividends at a rate of 25%, rather than the reduced rates of 5% or 15% under the Treaty (the lower rate applying to shareholdings of more than 10% of the voting stock). In addition, LLCs would be subject to Canadian tax of approximately 25% on capital gains from the disposition of shares of private Canadian corporations (referred to as "taxable Canadian property"), rather than being fully exempted from Canadian capital gains tax in most cases by the Treaty.

The Protocol does not deem an LLC to be a resident of the United States for the purposes of the Treaty. Instead, it treats an LLC in the same way as a partnership so that the CRA will look through the LLC to its members to determine whether Treaty protection is available to a particular member on the basis of the member being a United States resident. This approach will create administrative headaches for LLCs with large numbers of members, such as private equity funds, which may nullify its benefits as a practical matter.

In the case of withholding taxes on dividends, the Canadian resident corporate payor will typically not be aware of the residence of the members of a widely held LLC. As a result, it will still be required to withhold 25% of the dividend payment and each member of the LLC that is a resident of the United States will be required to seek a refund from the CRA of the excess tax that was withheld.

Where an LLC has disposed of shares of a private Canadian corporation, the purchaser will be obligated to withhold 25% of the purchase price and remit it to the CRA unless it receives a tax clearance certificate from the LLC. In order to obtain this certificate, it will be necessary for the LLC to provide the names, addresses, social insurance numbers, corporate account numbers, non-resident account numbers and percentage interests in the LLC of every member. Obtaining the clearance certificate from the CRA can take many months. In addition, each member will be required to file an income tax return with the CRA with respect to the sale of the shares.

Due to these onerous administrative requirements, we expect that widely held LLCs will continue to structure their Canadian investments through intermediary holding companies in countries such as Barbados and Luxembourg rather than invest directly in Canada.

This update is intended as a summary only and should not be regarded or relied upon as advice to any specific client or regarding any specific situation. If you would like further information regarding the issues discussed in this update or if you wish to discuss any aspect of this commentary, please feel free to contact:

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