TAX - CANADA

LLCS AND CANADIAN BRANCH TAX

by Henry Chong

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The 5th Protocol (the "Protocol") to the Canada-U.S. Tax Treaty (the "Treaty") added Article IV(6) to extend Treaty benefits to U.S. limited liability companies ("LLCs") that are fiscally transparent for U.S. tax purposes. While providing relief generally, the approach taken by Article IV(6) does not necessarily extend treaty benefits to LLCs in all circumstances. For instance, an LLC that operates in Canada through a branch or LP may be denied the benefits of the Treaty reduced rate of branch tax where the members of the LLC are not corporations entitled to the benefits of the Treaty. While this result may be questionable policy, it appears to be consistent with the general approach of Article IV(6) to Treaty entitlements contemplated by the Treaty.

The CRA's longstanding position has been that an LLC that is a flow through is treated as a corporation that is not a resident of the U.S. for purposes the Treaty. This position has not been changed by *TD Securities*. The Protocol was intended to provide general relief by granting LLCs derivative rights to Treaty relief from Canadian tax to the same extent that a member of the LLC would be entitled to such benefits if the same income was earned by such member directly. This look through applies where the residency and "same treatment" requirements of Article IV(6) are met. While this approach generally permits LLCs to claim Treaty benefits based on the entitlement of its members, in the case of the branch tax, it does not appear to always reach the appropriate result.

The branch tax generally applies to the un-reinvested income of a branch of a non-resident corporation (including an LLC) at the rate of 25% unless reduced by treaty. It is a substitute for the dividend withholding tax that would apply if the business was conducted through a Canadian subsidiary and is intended to provide parity between a branch and subsidiary. The CRA's position on the entitlement of a LLC's branch to Treaty benefits in Document 2009-0339951E5 (the "TI") is that the $500,000 exemption and 5% rate only apply if the income attributable to the LLC's Canadian PE was derived pursuant to that Article by a corporation that is a U.S. resident and a qualifying person under LOB.

The CRA's general position that an LLC will only be entitled to Treaty benefits to the extent that the members of the LLC meet the requirements of the applicable Treaty article is arguably a reasonable reading of that provision in the context of the Treaty as a whole. As per the TI, the LLC would be subject to branch tax under the Act based on the CRA's position that it is a corporation. Where the look through rule in Article IV(6) applied, the member deriving the income under that provision would then have to meet the requirements of Article X(6) – corporate status according to the TI - to access Treaty relief. This general approach, if not the result, appears to be supported by the wording of the Treaty, specifically Article X(2). Under that Article, Canadian withholding tax on a dividend from a Canco is reduced to 5% where the recipient is a U.S. corporation that otherwise qualifies for Treaty benefits and meets the requisite 10% share ownership requirement. Where the Canco shares are held through an LLC, Article X(2)(b) attributes the LLC's ownership of Canco shares to its members for purposes of determining whether any of them meet the requirement for the reduced treaty rate. Such an attribution rule would not be required if share ownership did not have to be satisfied at the member level.

While the TI's approach may be a reasonable, the policy rationale is less clear. Provided that LOB requirements are met, there does not appear to be any reason to limit the Treaty branch relief to LLCs whose members are corporations. Certainly that issue is not relevant where a U.S. corporation is subject to branch tax nor does is it required to maintain the branch tax as a substitute for dividend withholding tax for LLCs. Instead, the TI's position appears to be the (unintended) result of the conflict between Canada's treatment of LLCs under domestic law and the Treaty's treatment under Article IV(6). Canada taxes the LLC based on its corporate status. The Treaty, however, requires a look through to the LLCs members to determine the LLC's Treaty benefits. This is similar to the problem pre-Protocol. If one or the other approach applied alone, the LLC would either be subject to branch tax and entitled to Treaty benefits or subject to tax and entitled to benefits based on the identity of the LLC members. Applied together, the LLC is subject to tax but cannot qualify in its own right for Treaty protection. This issue does not appear to arise for other income covered by the Treaty as Canadian tax in those cases will be based on the character of the payment (i.e. interest, dividends) and not of the LLC. The Treaty will then looks at the LLC's members to determine its Treaty benefits. The CRA's treatment of LLCs as a corporation does not play a role in either analysis.

As a pure branch may not be common, this may not be a significant issue in practice. There are also alternative structures that can produce a similar U.S. tax result. There may also be an argument that the reduced rate under Article X(6) applies so long as there are "earnings" subject to branch tax under the Act. Under this view, LLC members considered to derive earnings that have been subject to branch tax would benefit from the reduced rate regardless of corporate status but subject to LOB. This appears to be consistent with the CRA's general approach to Article IV(6), avoids the conflict without (overly) abusing the wording of Article X(6) and produces the appropriate result. Based on the TI, however, CRA may not be sympathetic.

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