tax notes international

Volume 58, Number 3 ■ April 19, 2010



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Reprinted from *Tax Notes Int'l*, April 19, 2010, p. 199

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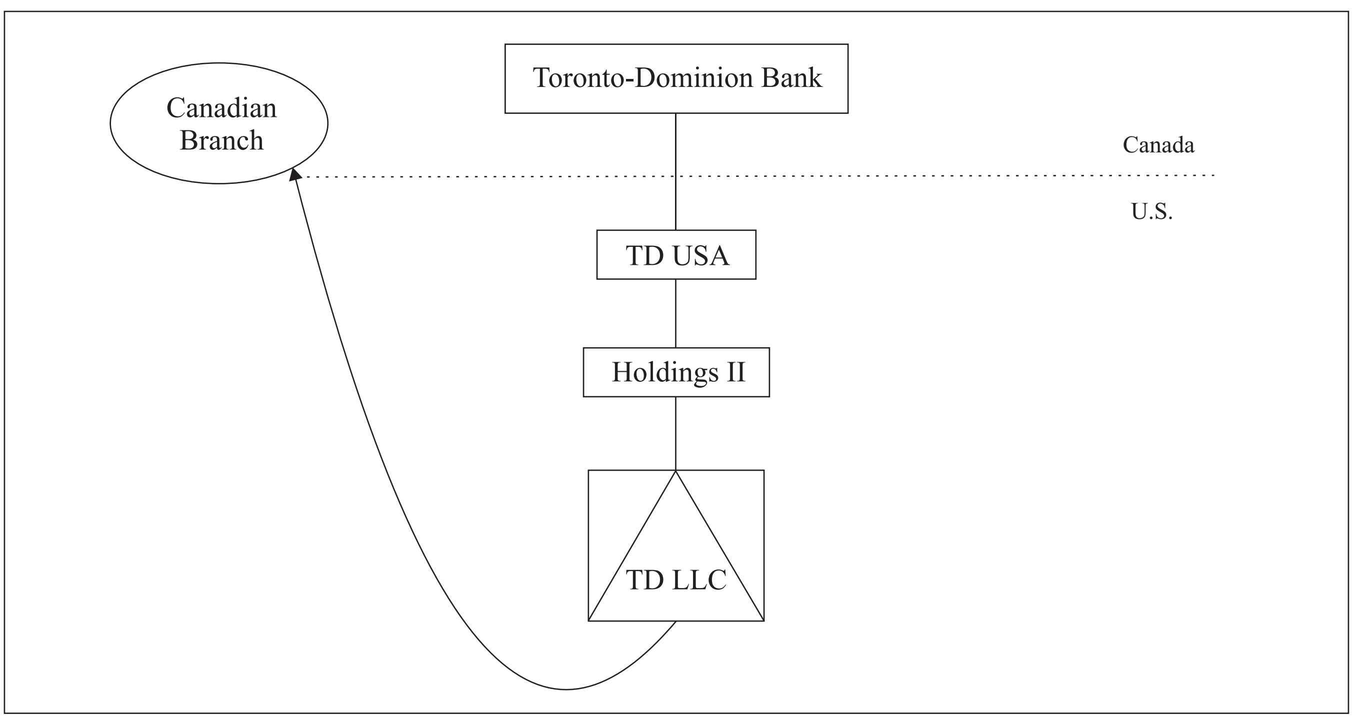
The Tax Court of Canada on April 8 allowed the appeal in *TD Securities (USA) LLC v. Her Majesty the Queen*, concluding that a Delaware limited liability company was liable to tax in and therefore a resident of the United States for purposes of the Canada-U.S. income tax treaty. (For the Tax Court of Canada's decision, see *Doc 2010-7938* or *2010 WTD 69-23*.)

The court concluded that the LLC was a U.S. resident because the United States retained and exercised the jurisdiction to tax the worldwide income of the appellant (including its Canadian branch income) on a comprehensive basis, even though the taxation occurred at the level of its U.S. resident member. This case overturns the Canada Revenue Agency's long-established position that LLCs that are fiscally transparent for U.S. purposes cannot be U.S. residents for treaty purposes before the application of the fifth protocol to the Canada-U.S. treaty (which did not apply to the tax years at issue).

## Facts

The Toronto-Dominion Bank is a widely held Canadian bank with several foreign subsidiaries. The appellant, TD Securities (USA) LLC (TD LLC), is a Delaware LLC that is a disregarded entity for U.S. federal income tax purposes. TD LLC is a registered U.S. broker-dealer that provides financial services in capital markets and maintains a Canadian branch to provide some services to its U.S. customers. The sole member of TD LLC is a Delaware corporation (Holdings II) that is indirectly owned by the Toronto-Dominion Bank. For U.S. tax purposes, the income of TD LLC and the income of its parent Holdings II are included in the consolidated return filed by the U.S. parent of Holdings II (TD USA). (See figure.)

Canada taxes the profits attributable to the Canadian branch of TD LLC under its regular income tax rules and also levies a separate tax on the profits of the



branch that is meant to be equivalent to the dividend withholding tax that would apply to a Canadian subsidiary paying a dividend to a foreign parent. This branch tax is levied under Part XIV of the Income Tax Act (Canada) at the rate of 25 percent of branch after-tax income.

Under article 10, paragraph 6 of the Canada-U.S. treaty, the branch tax rate applicable to U.S. residents is reduced to 5 percent. At issue in this case was whether TD LLC could claim the benefit of article 10, paragraph 6 of the treaty to reduce the rate of branch tax exigible from 25 percent to 5 percent for its Canadian branch income during the tax years ending October 31, 2005, and October 31, 2006. Canada took the position that TD LLC was not entitled to the treaty-reduced rate on the basis that it was not a resident of the U.S. for purposes of the treaty because it was not itself liable to tax in the U.S.

## Arguments

Article 1 of the Canada-U.S. treaty states that the treaty generally applies to persons who are residents of either or both Canada and the United States, and article 2 provides that the treaty applies to income taxes imposed on behalf of Canada and the United States ''irrespective of the manner in which they are levied.'' The term ''resident'' is defined in article 4, paragraph 1 as any person that under the laws of either Canada or the United States was ''liable to tax therein by reason of that person's domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature.''

During the relevant tax years, the treaty did not specifically address, or restrict, the entitlement to relief for income derived through a fiscally transparent entity. The CRA argued that under a strict construction of article 4, paragraph 1 of the treaty, TD LLC was not itself liable to tax in the United States (as required by the treaty to be considered a resident) because it was not subject to tax in the United States on its own account by virtue of being a disregarded entity for U.S. tax purposes. Thus, the CRA argued that the Canadian branch income of TD LLC would have been eligible for treaty benefits only if it had elected to be treated as a corporation for U.S. federal income tax purposes, and it maintained that TD LLC was not entitled to relief under the treaty because it was generally treated as fiscally transparent in the United States.

TD LLC put forth two arguments for the application of the benefits under article 10, paragraph 6. First, it said benefits should apply because TD LLC was liable to tax in the United States to the extent that the U.S. retained and exercised the jurisdiction to tax the worldwide income of TD LLC, whether or not it paid tax on that income. In other words, the availability of treaty benefits should not turn on whether TD LLC made a particular election under U.S. domestic tax law, particularly when that election would not have had any material effect on the manner in which the U.S. taxed its worldwide income. Second, the appellant argued that benefits applied because the worldwide income (including the Canadian branch income) derived through TD LLC was taxed in the United States in the hands of Holdings II, which clearly was a U.S. resident for treaty purposes. Consistent with the look-through approach endorsed by the OECD and generally adopted by Canada and the United States regarding income derived through other fiscally transparent entities, benefits under the treaty should apply for the income derived through TD LLC by a U.S. resident.

## Tax Court Decision

The Tax Court of Canada found that during the tax years at issue, the United States retained its jurisdiction to tax TD LLC on a comprehensive basis. That the United States exercised its jurisdiction by taxing the income in the hands of Holdings II did not lead to the conclusion that TD LLC was not liable to tax or that benefits under the treaty were therefore unavailable, the court held.

The court noted that previously the Canadian and U.S. tax authorities had interpreted the treaty liberally and with a results-oriented approach when considering whether treaty benefits should be available to entities that are not required to pay tax under the relevant domestic law. In this regard, the court noted that past Canada-U.S. treaty amendments specifying that tax-exempt entities and governmental entities constitute residents for treaty purposes were effected as ''clarifications'' rather than changes in law and did not require Canadian and U.S. tax authorities to change their practice of granting treaty benefits to such entities.

The court also cited other situations in which Canadian tax authorities had administratively interpreted the treaty in a liberal manner so as to make benefits available when this was consistent with the spirit of the treaty, as with S corporations and partnerships. The sole exception to that approach was Canada's treatment of LLCs. In light of the ''overwhelming consistency'' of this approach, the court held that it was not intended that an entity whose income was comprehensively taxed in the other contracting state would be denied the benefit of a treaty simply because its income was taxed by the other country at the level of its shareholders, members, or partners.[1]

Given that the Canadian-source income of TD LLC had been fully taxed in the United States, the court concluded that the context, object, and purpose of the

[1]In this regard, the court reviewed the provisions of the OECD model treaty and related commentaries relating to partnerships, as well as the recently enacted fifth protocol to the Canada-U.S. treaty and technical explanation thereto (which deal

**(Footnote continued on next page.)**

treaty would not be achieved (and indeed would be frustrated) if that income did not enjoy the benefits of the treaty. In so concluding, the court reiterated (as it has in other cases involving treaty interpretation) that the proper approach to interpreting a treaty, including the Canada-U.S. treaty, is to follow the interpretive approach taken by other OECD countries, the OECD model treaty, and related commentaries.

specifically with the provision of benefits to LLCs), and concluded that when it is appropriate that treaty benefits be extended to an item of income, it can be done at the entity level or the member level and should not be frustrated by an overly technical reading of the wording.

This decision is important because it overturns the long-standing position of the CRA that disregarded LLCs cannot be U.S. residents and access benefits under the Canada-U.S. treaty. The court indicated that the factual context of interpreting the treaty may have been different in a situation that involved an abuse, or when the income of the LLC had not been liable to tax in the United States in the hands of its parent.

The CRA has until May 10 to appeal the decision of the tax court to the Federal Court of Appeal. ◆