

“ECI” and its Trap for Unwary Canadian Investors in Partnerships and LLCs

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by Kendall R. Fisher and John D. Hollinrake, Jr.

A Canadian which holds a partnership interest in a U.S. or non-U.S. partnership that has “effectively connected income” (“ECI”) is subject to U.S. tax withholding with respect to the Canadian partner’s allocable share of the partnership’s ECI. That withholding tax must be remitted by the partnership to the IRS irrespective of whether any distributions are made by the partnership in that tax year and irrespective of the Canadian partner’s ultimate U.S. federal income tax liability for that tax year. For this purpose, a “partnership” includes any entity classified as a partnership for U.S. tax purposes, including a limited liability company or “LLC” classified as a partnership.

ECI generally includes all income from U.S. sources that is connected with the conduct of a U.S. “trade or business”. The term “trade or business” generally includes the performance of personal services, but also includes and excludes specific types of activities. The determination of whether activities rise to the level of constituting a trade or business requires specific analysis.

Canadian partners in partnerships with ECI will be required to obtain a U.S. taxpayer identification number and to file a U.S. federal income tax return, as the activities of a partnership constituting a trade or business will be attributed to the Canadian partner. A Canadian partner will generally be eligible to claim a credit for their share of the ECI withholding tax remitted by the partnership in determining their aggregate U.S. tax liability. Accordingly, the withholding tax is not an additional tax.

In addition to the foregoing, a Canadian which transfers or disposes of an interest in a partnership with ECI is generally subject to a 10% U.S. withholding tax, unless an exception applies.

Exceptions to the 10% U.S. withholding tax generally assessed against transferors of interests in U.S. partnerships will be discussed in a subsequent blog post.

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