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Private Equity Funds — Selected Canadian Tax Issues

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Non-Canadian private equity fund sponsors face a number of Canadian tax issues when investing in Canada, engaging Canadian service providers, and raising capital from Canadian investors. Such issues include: the fund or its investors being considered to carry on business in Canada and thereby having to file Canadian tax returns and possibly pay Canadian tax on net income; the potential status of portfolio company shares as taxable Canadian property (''TCP''), which can lead to obligations to file tax returns, apply for clearance certificates, withhold a portion of the purchase price paid for such shares, and pay tax on gains realized on their sale; the potential denial of tax treaty benefits as a result of new anti-treaty shopping measures; the issuance of convertible debt by a portfolio company leading to potential Canadian withholding tax; the choice of whether to adopt a parallel fund structure to avoid certain Canadian tax inefficiencies; and the potential application of Canadian sales taxes to management fees and similar payments. An overview of each of these issues is provided below.

CARRYING ON BUSINESS IN CANADA

Non-Canadians that ''carry on business in Canada'' within the meaning of the *Income Tax Act* (Canada) (the ''ITA'') are subject to Canadian tax filing obligations and may be required to pay regular Canadian tax on net income attributable to their Canadian activities. The amount of activity sufficient to meet the ''carrying on business in Canada'' threshold is low. Non-Canadian private equity funds carrying on activities in Canada, either directly or through the use of Canadian service providers, should be cognizant of these rules as they could impact the fund and its investors.

Two types of analysis are required to determine whether Canadian activities undertaken by a non-Canadian constitute ''carrying on business in Canada'': judicial criteria must be applied and the Canadian activities must be evaluated in the context of a statutory deeming rule.

Criteria found to be relevant by Canadian courts when determining whether a non-Canadian ''carries on business in Canada'' include the existence of bank accounts in Canada, entering into contracts in Canada, decision-making activity situated in Canada, the presence of employees or agents of the non-Canadian in Canada who have the authority to act on its behalf, and business activity carried out in Canada resulting in the realization of profit. Of these factors, entering into contracts in Canada and the realization of profit from conducting activities in Canada are generally the most relevant.

In addition to the foregoing judicial criteria, section 253 of the ITA deems a non-Canadian to ''carry on business in Canada'' where, among other things, the non-Canadian solicits orders or offers anything for sale in Canada through an agent or servant.

From the perspective of a non-Canadian private equity fund, the presence in Canada of employees or agents of the fund sponsor, including Canadian residents retained to provide investment management or other services on behalf of the fund, may give rise to ''carrying on business in Canada'' concerns. Fund sponsors that do not wish their funds and investors to fall within Canadian taxing jurisdiction or file Canadian tax returns should develop operating procedures governing activities that may and may not be undertaken by any employees travelling to Canada. Activities undertaken by Canadian service providers to the fund should be similarly circumscribed.

''Carrying on business in Canada'' concerns may be mitigated by ensuring neither the fund nor the fund sponsor has a permanent establishment in Canada within the meaning of any applicable income tax treaty. Typically, relevant treaty jurisdictions include those in which the fund, fund sponsor, and (where the fund is treated by Canada as fiscally transparent) fund investors, are entitled to treaty benefits. We discuss treaty issues further, below, in the context of treaty shopping.

Relief from the consequences of ''carrying on business in Canada'' may also be provided by a tax safe harbour in section 115.2 of the ITA. This rule permits ''Canadian service providers'' to provide ''designated investment services'' in respect of ''qualified investments'' to non-Canadian investment funds. Where applicable, such a fund (or, in the case of a fund structured as a partnership, non-Canadian investors in the partnership) will not be found to ''carry on business in Canada'' solely because of the provision to the fund of such services. In the context of a non-Canadian private equity fund, ''designated investment services'' includes advice related to the acquisition and selling of portfolio companies that are ''qualified investments,'' exercising rights incidental to the ownership of such companies (such as voting), and entering into and executing agreements with respect to such companies.

The safe harbour contains a number of restrictions. For example, a share in the capital stock of a private portfolio company, or an interest in an unlisted partnership or trust, will not be a ''qualified investment'' for purposes of the safe harbour where more than half the value of the share or interest is derived from Canadian real estate or resource property. Similar restrictions apply to publicly traded entities where more than 25% of the issued shares of any class of capital stock of the corporation or of the total value of interests in the partnership or trust are owned by the fund. The safe harbour also prohibits certain entities affiliated with a ''Canadian service provider'' from investing in the non-Canadian fund. Further, the safe harbour will not apply to a fund structured as a corporation or trust if it is promoted principally to Canadian resident investors, or at any time when investments in the fund have been sold to Canadian investors and remain outstanding. Accordingly, reliance on the safe harbour requires a detailed analysis of the non-Canadian fund, its investors, fund sponsor, service providers, and proposed investments.

TAXABLE CANADIAN PROPERTY

Canada generally does not exercise taxing jurisdiction over gains realized by non-Canadians on the disposition of property, save for gains realized on the disposition of TCP. A non-Canadian will be taxable in Canada on one-half of the net capital gain realized on the disposition of TCP, subject to treaty relief. Canada levies this tax pursuant to various compliance and reporting mechanisms which may, depending on the circumstances, require the purchaser to withhold up to 25% of the purchase price and/or a clearance certificate to be obtained from the Canada Revenue Agency (''CRA''). In addition, a non-Canadian's disposition of TCP, whether or not resulting in a gain, will generally trigger a Canadian tax return filing requirement. If a fund invests in Canadian portfolio companies — particularly those in the infrastructure, real estate, or resource sectors — it needs to be aware of the Canadian tax rules relating to TCP.

The definition of TCP would include the shares of a Canadian portfolio company at least 50% of the value of which is derived, directly or indirectly, from real or immovable property situated in Canada, Canadian resource property, or timber resource property (or options or interests in respect of the foregoing) at any time during a 60-month period prior to their sale.

Private equity funds currently invest predominantly in Canadian bio-tech, clean-tech, and high-tech companies, the shares of which are unlikely to constitute TCP. However, the value of a company's technology or goodwill may fluctuate, and if the company is operating a plant or has acquired office space, the relative value of such assets may at some point during the prior 60 months cause its shares to be TCP. Accordingly, there is a risk that a non-Canadian private equity fund (or, where the fund is structured as a partnership, its members)[1] may be subject to the foregoing regime with respect to the disposition of shares of a portfolio company. Under such circumstances, compliance and reporting obligations can be onerous, and

[1] Currently, such a fund may file one notification on behalf of all non-Canadian partners on the condition that sufficient information about each individual partner is provided. However, the fund will not be able to file a single tax return on behalf of all of the partners. Generally, each partner will be required to file a Canadian tax return. Any tax treaty relief will be applied at the individual partner level.

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the period during which any withheld purchase price remains unavailable to the fund and its investors can be lengthy. As discussed in more detail below, this situation can be particularly cumbersome where both Canadian residents and non-Canadians invest simultaneously in a single partnership.

TREATY SHOPPING

The Canadian government has signaled that it intends to introduce new rules to limit the circumstances in which tax treaty benefits may be claimed by intermediary holding vehicles resident in treaty jurisdictions. Private equity investors often use such investment vehicles when making investments into Canada, for a variety of reasons. These include limiting tax reporting and filing obligations for multiple investors, use of a common jurisdiction for multiple investors, access to bilateral investment treaties, and access to bilateral tax treaties that can result in reductions in withholding tax rates on interest, dividends, and royalties or access to capital gains exemptions.

In 2014, the Canadian government proposed to introduce into domestic law a new treaty override rule. The proposed rule, if enacted, would have applied where one or more persons not entitled to the benefits of a particular tax treaty with Canada use an entity that is a resident of a country with which Canada has concluded a tax treaty in order to obtain Canadian treaty benefits. For example, this could include a Luxembourg or Netherlands holding company used to reduce or eliminate tax on Canadian investments by a private equity fund whose investors are themselves not resident in such treaty country. The intention was that the proposed rule would have denied the treaty benefits sought through such an arrangement. The government subsequently withdrew this proposal, explaining that it would wait to consider anti-treaty shopping measures recommended by the OECD/G20 Base Erosion and Profit Shifting (''BEPS'') project.

The Organization for Economic Cooperation and Development's final report on Treaty Abuse, which was released in October 2015, proposes OECD Model Treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Oversimplifying somewhat, the report recommends that countries adopt a limitation on benefits (''LOB'') rule and/or a ''principal purpose test'' (''PPT'') rule. The LOB rule, which may apply to limit the availability of treaty benefits to an entity that is otherwise a resident of a Contracting State, sets out objective conditions that are meant to ensure that there is a genuine connection or sufficient link between the entity and its residence state. The PPT rule is a general anti-abuse rule that denies the availability of treaty benefits where one of the principal purposes of a transaction or arrangement is to obtain such benefits, unless the granting of the benefits accords with the object and purpose of the relevant treaty provision. Either or both of these rules could deny treaty benefits to a holding company set up in a treaty country by a private equity fund whose investors are largely resident outside that country. However, the OECD has not completed its work on how these rules are meant to apply to private equity, infrastructure, and hedge funds.

At present, there is thus little certainty with respect to whether and under what circumstances Canadian treaty benefits may be claimed by an intermediate holding vehicle set up by a private equity fund. One possible development may be that Canada reintroduces a unilaterally imposed, domestic treaty override rule. Alternatively, Canada may continue to wait until the OECD has completed its work on bilateral approaches to treaty benefits in the private equity fund context. In any event, the ITA already contains a general anti-avoidance rule that may potentially apply to deny treaty benefits. None of this is to say that treaty-based holding companies should not be established by private equity funds for investment into Canada, but the shelf life of such structures may be limited.

CONVERTIBLE DEBT

Canadian private issuers often issue convertible debt to investors, including venture and private equity funds, as a means of providing a fixed return with potential equity upside. Nonresident investors will wish to avoid there being Canadian withholding on the various payments under the convertible debt, such as fixed interest payments and the premium payable on conversion (the excess of the value of the shares into which the debt is converted and the issue price of the debt).

Canada exempts most interest paid on arm's-length indebtedness from domestic withholding tax. However, where interest is ''participating debt interest'' within the meaning of subsection 212(3) of the ITA, withholding tax will apply at a rate of 25%, subject to available treaty relief. The definition of ''participating debt interest'' generally includes interest which is contingent or dependent on the use of or production from property in Canada or that is computed by reference to revenue, profit, cash flow, commodity price, or similar criteria or by reference to dividends paid or payable to shareholders of any class of shares of the capital stock of a corporation.

In the private equity fund context, the question arises whether interest or deemed interest payable on convertible debt issued by a Canadian portfolio company to arm's-length non-Canadians is ''participating

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debt interest'' by virtue of being determined in whole or in part by reference to shares of the portfolio company into which the debt may or must be converted.

The Canadian tax landscape surrounding convertible debt instruments is complex and in flux. Numerous issues must be navigated in order to conclude that no portion of the interest payable or conversion premium on convertible debt is subject to withholding tax by virtue of being ''participating debt interest.'' First, the convertible debt instrument must be indebtedness for commercial law purposes. Where convertible debt is properly characterized as debt under the relevant commercial law, Canadian tax jurisprudence dealing with the correct treatment of any in-the-money conversion premium must be considered. Also relevant are the administrative views of the CRA, which has so far been unable to articulate a clear set of parameters for convertible debt, the interest on which the CRA would consider exempt from withholding tax.

PARALLEL FUND STRUCTURES

A non-Canadian private equity fund that expects to have significant investor capital sourced in Canada and to invest in Canadian portfolio companies should consider forming a separate fund restricted to Canadian investors that would invest in parallel with the main fund. This approach is generally more tax-efficient for Canadian investors, especially tax-exempt investors (which are a significant source of Canadian funding for private equity funds), when compared to investing in a partnership that has both Canadian and non-Canadian members. In addition to permitting certain tax-deferred entry and exit transactions for Canadian investors, a parallel fund avoids two significant indirect tax inefficiencies associated with investing in a partnership that has one or more non-Canadian members (a ''Non-Canadian Fund''):

(a) *Canadian investors indirectly becoming subject to the TCP regime.* The rules discussed above relating to TCP, including the requirement to withhold a portion of the purchase price and/or obtain a clearance certificate, apply not only to nonresident corporations and individuals but also to any partnership that has one or more non-Canadian investors. Therefore, if the Non-Canadian Fund sells property (e.g., shares in the capital stock of a Canadian portfolio company) that are TCP, this can result in the TCP rules being indirectly visited upon Canadian investors.

(b) *Canadian investors indirectly becoming subject to Canadian withholding tax on passive payments.* The ITA provides that if a payment subject to Canadian withholding tax (e.g., interest, dividends, royalties, etc.) is made by a Canadian portfolio company to a Non-Canadian Fund, the entire payment is treated as paid to a nonresident of Canada for Canadian tax purposes and thus subject to Canadian withholding tax at 25%, subject to available treaty relief. Recently, the CRA has adopted an alleviating administrative policy whereby no amount in respect of the portion of such payments allocable to a Canadian resident partner of a Non-Canadian Fund would be required to be withheld by a Canadian portfolio company. However, this policy, for which there is no legislative basis, does not expressly supersede past contrasting published positions. Some Canadian investors have expressed uneasiness with this uncertainty and are not receptive to investing jointly with non-Canadians in a fund that is subject to Canadian withholding tax. While a concern over withholding taxes is often downplayed where portfolio companies are not expected to pay material amounts of dividends, it should be noted that common exit transactions can nonetheless result in withholding tax arising on net proceeds distributed to a Non-Canadian Fund by way of a dividend or share redemption proceeds.

As a result of these concerns, many Canadian investors insist on the use of a parallel fund. This is typically easier for Canadian private equity fund sponsors to accommodate than for non-Canadian sponsors, who would otherwise not consider forming a Canadian partnership having a Canadian resident general partner.

CANADIAN SALES TAX CONSIDERATIONS (GST/HST)

Under Canadian goods and services tax legislation, management services are taxable unless they are specifically exempt. Generally, such an exemption is available for management services provided by a Canadian or non-Canadian resident to a non-Canadian fund. Accordingly, Canadian goods and services tax will generally not apply to management fees rendered to the typical non-Canadian private equity fund. However, a number of private equity fund structures, including the parallel fund structure described above, may require the allocation of aggregate goods and services tax (''GST'') or harmonized sales tax (''HST'')[2] liability among Canadian and non-Canadian funds in

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[2] Ontario, New Brunswick, Nova Scotia, Prince Edward Island, and Newfoundland and Labrador have adopted a harmonized sales tax system wherein the provincial component of such tax is effectively included in the amount paid to the Canadian federal government. Quebec has in place a comparable arrangement.

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proportion to their invested capital. Accordingly, non-Canadian private equity funds should consider GST/HST issues in their Canadian tax planning.

Management fees of approximately 2% have traditionally been paid by Canadian private equity funds for services rendered (directly or indirectly) by a general partner. Such fees were historically subject to GST at a rate of 5%. More recently, some Canadian provinces have harmonized the federal GST with their provincial sales taxes in the form of HST, resulting in an increase in the overall tax burden to which such fees are subject. For example, the sales tax rate applicable to a traditional management fee in Ontario is now 13%, and has reached the heights of 14.97% in Quebec (two of the most active provinces in Canada in terms of foreign private equity investment).

While the increase in sales tax applicable to management fees may seem innocuous, a fund will generally neither be able to register for sales tax purposes nor be able to claim input tax credits to offset HST paid in respect of management expenses. The result is that sales tax paid by a fund on management fees is not recoverable. Given this economic impact, some funds have explored alternative means of remunerating fund sponsors (acting in their capacity, either directly or indirectly, as general partner). There are a number of potential structures to consider which, depending on the circumstances, may alleviate this burden for private equity funds.

CONCLUSIONS

The foregoing is a general description of Canadian tax issues that face non-Canadian private equity funds and their sponsors when investing in Canada, engaging Canadian service providers, and raising capital from Canadian investors. The nature of a fund's Canadian activities and investments, and the legal form and tax jurisdiction of the fund, the fund sponsor, and, in certain cases, fund investors are all relevant factors in assessing the impact of Canadian tax laws on a non-Canadian private equity fund having a Canadian nexus. Given the low threshold for the application of some of these rules, and the unusual circumstances in which others may apply, they should be considered even where the amount of a fund's Canadian activity appears to be *de minimis*.

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