Structuring Venture Capital Funds

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PRÉCIS

Le marché canadien des souscriptions privées, qui se caractérise principalement par son activité dans trois segments distincts — le rachat et le financement des entreprises connexe, l'investissement mezzanine, et le capital de risque — a enregistré une hausse importante et s'est beaucoup diversifié au cours de la dernière décennie. L'augmentation enregistrée dans le segment du capital de risque découle principalement de la demande sans cesse croissante de financement de risque par les nouvelles sociétés de technologie. Un autre facteur qui a contribué à cette croissance est l'appétit des grands fonds privés de capitaux américains pour les placements dans les sociétés canadiennes, qui a été en grande partie alimenté par la demande sans cesse croissante de placements de qualité de la part des investisseurs institutionnels.

Les placements de capital de risque attirent de plus en plus d'importants fonds de capitaux de la part des investisseurs institutionnels et autres investisseurs avertis et, par conséquent, le besoin de répondre aux préoccupations fiscales particulières à ces investisseurs s'est accru. Dans le cas d'investisseurs institutionnels, comme les caisses de retraite, les fonds de capital de risque ont personnalisé leurs placements pour qu'ils répondent aux besoins particuliers de ces investisseurs. Par exemple, au Canada, les promoteurs de fonds ont dû structurer les fonds pour éviter la classification à titre de biens étrangers; dans un contexte étranger, les structures mises en place doivent faire en sorte qu'aucun impôt canadien n'est à payer.

Bien qu'à ce jour les objectifs d'allégement fiscal dans le cadre de la structuration des fonds de capital de risque aient été largement atteints, le secteur du capital de risque doit encore faire face aux défis soulevés par des problèmes pratiques et des questions de réglementation. Une planification adéquate a permis de résoudre certains de ces problèmes, mais il est devenu de plus en plus évident que certains autres relèvent du milieu de la réglementation auquel les fonds sont assujettis. Cet article aborde les questions de structuration et les sujets de préoccupation qui pourraient nécessiter des changements législatifs. Nous tenterons également de fournir aux investisseurs et à leurs conseillers fiscaux un guide pour l'évaluation de ces questions pour permettre un cadre législatif plus souple favorisant la croissance des fonds de capital de risque.

* Of Goodman and Carr LLP. The author thanks Ivan Grbesic and David Stevens for their research into the Canadian venture capital industry and certain partnership law issues discussed, respectively, and Barry Naiberg for his valuable comments on various drafts of this article.

ABSTRACT

Canada's private equity market, characterized chiefly by activity in three distinct market segments—buyout and related corporate finance, mezzanine investment, and venture capital—has experienced major growth and diversification over the last decade. In the case of venture capital, one of the main reasons for growth was the ever-increasing demand for risk financing from emerging technology firms. Another factor that has contributed to growth is the large and sophisticated US private equity funds' appetite for investment in Canadian companies, largely fuelled by an ever-increasing demand for quality investment on the part of institutional investors.

Given that venture capital investments are attracting increasingly large pools of capital from institutional and other sophisticated investors, the need to accommodate the specific tax concerns of such investors has also increased. In the case of institutional investors such as pension funds, venture capital funds have tailored their investments to meet the specific needs of their investors. For example, in the domestic context, fund sponsors have been required to structure such funds to avoid foreign property classification; in the foreign context, structures have been required to ensure that no Canadian tax will be payable.

Although the goals of tax mitigation in the structuring of venture capital funds have been largely met to date, regulatory and practical issues pose challenges to the venture capital industry. Some of these issues have been successfully managed with proper planning, but it has become increasingly clear that a number of them relate to the regulatory environment such funds are subject. This article discusses these structuring issues and the potential areas of concern that may require legislative reform, and endeavours to provide investors and their tax advisers with a guide for assessing these issues and achieving a more workable legislative framework to foster the growth of venture capital funds.

KEYWORDS: VENTURE CAPITAL ■ FUNDS ■ LIMITED PARTNERSHIPS ■ TAX STRUCTURES ■ FOREIGN PROPERTY ■ NON RESIDENTS

CONTENTS

INTRODUCTION

This article describes how a typical venture capital fund is structured and the potential challenges of tailoring such a fund to the specific tax concerns faced by investors. The first part of the article provides a brief overview of the Canadian venture capital industry and the types of funds and capital under management. The second part addresses preliminary structuring issues, such as the choice of investment vehicle and the format of a typical cross-border fund. The jurisdiction of formation and entity classifications are also discussed. The third part addresses the foreign property issues that arise from the choice of vehicle. The qualified limited partnership, the foreign property solution of choice, is analyzed with reference to the tailoring of the vehicle to meet the conditions of the Income Tax Act[1] while at the same time

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

satisfying the objectives of the venture fund format. Finally, the fourth part deals with the use of parallel investment vehicles in which several entities, each structured to suit a particular type of investor, form a fund to invest in common. In the domestic context, issues relating to the nature of the investments and the status of the fund vehicle are discussed, with an emphasis on the tax consequences of using separate partnerships to invest side by side. In the foreign context, the compliance issues that can result when Canadian and non-resident investors invest in the same partnership are discussed. In order to avoid problems and insulate non-resident investors from Canadian tax, the use of a separate investment vehicle subject to the safe harbour rules of section 115.2 is analyzed, and both the benefits and the deficiencies of the provision are highlighted.

THE CANADIAN VENTURE CAPITAL INDUSTRY[2]

The pool of capital being managed by the venture capital industry in Canada has increased significantly over the last 10 years. Unlike the market in the United States, where private independent funds dominate private equity markets, the market in Canada, which is estimated to have an aggregate of $49 billion worth of capital under management in 2002, is diverse: it is composed of several different types of venture capital funds, including institutional funds, private independent venture funds, labour-sponsored venture capital funds, corporate funds, institutional funds, and government funds.

Types of Funds and Capital Under Management

Institutional Funds

Pension funds and insurance companies generally set up in-house teams of private equity professionals to make direct investments on their behalf. Owing to their large asset base and the volume of assets they allocate to direct investment, such groups have emerged as important players in the buyout, mezzanine, and venture capital market segments. These funds accounted for the biggest share of the aggregate capital under management in 2002—$15.4 billion, or 38 percent of the aggregate.

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2 Unless expressly noted, the information set out below was obtained from the following sources: Macdonald & Associates Limited, *The Goodman and Carr LLP Report: Private Equity Canada 2002—An In-Depth Review of the Market*, report prepared for Goodman and Carr LLP (Toronto: Goodman and Carr LLP, 2003); Macdonald & Associates Limited, *The Canadian Venture Capital Industry: Sources of Capital and Implications for Industry Structure*, research paper prepared for the Task Force on the Future of the Canadian Financial Services Sector (Ottawa: Department of Finance, September 1998); and Jean-Philippe Cayen, "Venture Capital in Canada," Bank of Canada paper, June 21, 2001.

Except for the estimate of the aggregate private equity pool at $49 billion (an estimate composed of a pool of $40.5 billion captured by the private equity activity survey and an estimated $8.5 billion in outstanding funds under management), the remaining figures in this section reflect the responses provided by the entities who participated in the private equity survey.

Private Independent Venture Funds

Private independent venture funds are professionally managed private equity funds that raise capital from external sources of supply (primarily pension funds and insurance companies, and sometimes corporate investors) and have no affiliation with any other financial institutions. These funds, which are usually structured as limited partnerships with a life of 10 years, are generally focused on achieving a high rate of return on investments. These funds, which tend to be significant players in the industry, held assets totalling $10.3 billion in 2002, accounting for 25 percent of the aggregate.

Labour-Sponsored Venture Capital Funds

Labour-sponsored funds, as they are commonly known, emerged in Canada in the early 1980s as a distinct form of venture capital. These investment funds, which are structured in a manner similar to mutual funds, have a specific mandate to invest in eligible businesses, which are broadly defined as small and medium-sized Canadian companies. To encourage this mandate, the federal government and several provincial governments offer tax credits to Canadians to entice them to invest in these funds. As of 2001, there were more than 20 labour-sponsored funds in Canada. In 2002, labour-sponsored funds held $6.8 billion of the aggregate capital under management, representing 20 percent of the aggregate.[3]

Corporate Funds

Corporate funds are wholly owned subsidiaries or operating divisions of financial and industrial (or non-financial) corporations. Financial corporate funds are the largest component of the two groups. Since the restructuring of the banking sector in the 1980s, financial corporate funds have established a comprehensive presence in the various market segments (buyout, mezzanine, and venture capital); nearly all of Canada's commercial banks and non-bank financial institutions have a stake in the venture arena. Financial corporate funds in particular have become influential in the recent expansion of the Canadian buyout pools. Non-financial corporate funds, on the other hand, have a more prominent role in venture financing, because these funds have an interest in returns and more often than not in making strategic investments in opportunities that are congruent with the investors' own strategic technology, or because they provide synergy or cost savings to their own corporate group. Overall, corporate funds accounted for $4.7 billion, or 12 percent of the total capital under management in 2002.

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3 See http://www.investorlearning.ca. A great deal has been written about the detailed provisions of the statutes that govern labour-sponsored venture capital corporations and the tax expenditure premise underlying their use. For a comprehensive review of these issues, see Duncan Osborne and Daniel Sandler, "A Tax Expenditure Analysis of Labour-Sponsored Venture Capital Corporations" (1998) vol. 46, no. 3 *Canadian Tax Journal* 499-574.

Government Funds

Government funds usually make investments in the private equity market that would not otherwise be made by other funds, including investing in smaller deals, young technology companies, and activity located in rural or remote areas. Government funds held the smallest share of the aggregate capital under management in 2001 with $2.1 billion, accounting for 5 percent of the total.

Capital Supply of Private Equity Funds

In terms of capital supply, pension funds occupy the most important position in Canada; they represent $19.1 billion, or 42 percent of the aggregate supply in 2002. Individual investors are another major source of private equity supply; they are responsible for $9.6 billion, or 24 percent of the aggregate amounts contributed. The other key sources of private equity supply are the major Canadian financial and industrial corporations, which represent one-quarter of the amounts recorded overall, or $6.7 billion.

The remaining sources of private equity supply include insurance companies ($1.6 billion, or 4 percent), the federal and provincial governments ($2.1 billion, or 5 percent), foreign investors ($474 million, or 1 percent), and other capital sources (2 percent).

This article focuses on corporate venture funds and their sponsors—primarily, financial institutions and their merchant banking affiliates. With the exception of certain mark-to-market issues that arise in the context of venture funds sponsored by financial institutions, from a tax perspective the structuring issues relevant to corporate venture funds are largely the same as those faced by private independent venture funds. The issues discussed in this article are equally applicable to private independent venture funds that have no affiliation with a financial institution.

STRUCTURING ISSUES

Liability issues and tax considerations are the key factors in the structuring of a venture capital fund. This part of the article describes the basic determinants in structuring such a fund, using as a model a format that has been marketed to both Canadian-resident and non-resident investors. Related issues dealing with the jurisdiction of formation and entity classification are also addressed.

Choice of Vehicle

The investment vehicle of choice for most venture capital funds is a limited partnership. From a non-tax perspective, the limited liability offered to investors in a limited partnership is attractive given the risk inherent in venture capital investments. Further, a limited partnership may be effective in extending limited liability protection to investors who undertake certain activities with respect to such funds.[4]

4 Although venture capital partnerships are often structured as "Canadian partnerships," that classification depends merely on the residence of its partners. This raises the possibility of

Although other investment vehicles (for example, trusts) can be used, the potential risks associated with such investments make them more difficult to market than limited partnerships.

From a tax perspective, the conduit nature of a limited partnership is the key to its popularity. For tax-exempt investors that would not invest in a vehicle that subjects their share of income to tax, this is of paramount importance. For taxable investors, such transparency not only ensures that their share of income is not subject to a secondary level of tax, but allows them to use any losses—within limits—to shelter income from other sources.

From a Canadian marketing perspective, the greatest challenge faced by venture funds structured as limited partnerships is the fact that such investments are "foreign property" in the hands of certain tax-exempt investors. Accordingly, structures have developed to avoid such classification while at the same time preserving the fundamental economics of the venture capital investment. From a non-Canadian marketing perspective, the primary challenge is ensuring that non-resident investors will not be subject to Canadian tax, or that such tax will be minimized. The structures which have developed also address these concerns.

Venture Capital Structures

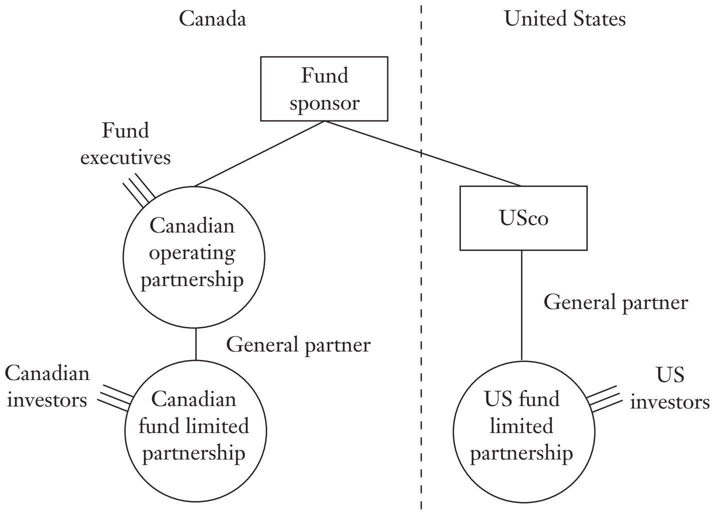
One venture capital fund structure that has been marketed to both Canadian-resident and non-resident (for example, US) investors is a two-tier domestic limited partnership with a foreign parallel investment limited partnership. This structure is shown in figure 1. The Canadian fund is established as a limited partnership with a general partner that is also a limited partnership. The general partner of the top-tier limited partnership is a newly incorporated corporation, wholly owned by the fund sponsor; the limited partners are the fund executives—either directly or indirectly, through holding companies or trusts.[5]

A parallel investment limited partnership is established for foreign (in this case, US) investors. To facilitate investment by investors (and depending on the applicable legal and/or tax requirements), one or more additional parallel investment entities (including one or more additional limited partnerships) may also be created. In the domestic context, such parallel structures have been used to permit investment in assets the main fund could not acquire and to ensure that the status of the fund sponsor does not taint the status of the partnership or the nature of its investment. Parallel structures have also been used to create "affiliate funds" for employees, which invest side by side with the main fund but on slightly more favourable terms

using a partnership formed under US or other foreign law to carry on the fund activities in Canada where the United States or other foreign jurisdiction provides greater limited liability protection than would otherwise similar Canadian legislation. This topic is discussed in more detail below.

5 Although a holding company would clearly provide executives with additional limited liability protection, trusts are often used for estate-planning purposes.

FIGURE 1



(for example, where fund expenses are reimbursed or loans are extended to employees to fund a portion of their commitments). From a foreign perspective, parallel structures have been used to avoid certain compliance issues and to provide non-residents with an added layer of protection against the possible imposition of Canadian tax.

The use of the two-tier partnership structure permits the Canadian fund to obtain "qualified limited partnership" status and avoid classification of its units as foreign property. This permits the fund to be marketed to a broader range of investors, including those subject to the foreign property limitations under the Act. However, as noted below, maintaining qualified limited partnership status may require certain commercial limitations on the terms and operation of the partnership agreement that governs such funds. If the fund was marketed only to private taxable investors, a more simplified partnership structure could be used.[6]

6 If qualified limited partnership status was not relevant, the fund could be structured on a "two-tier" unit basis. Under this model, the fund would consist of a limited partnership with two classes of units—class A units and class B units. Investors would subscribe for class A units and would be entitled to the "preferred return"; the executive group would subscribe for class B units representing the "carried interest" (see the discussion below relating to the typical venture capital structure). Given the requirement in regulation 5000(7)(d) that the units of a qualified limited partnership must be identical in all respects, such a structure could not be used in the qualified limited partnership context. See CCRA document no. 1999-0007237, May 11, 2000, wherein the Canada Customs and Revenue Agency (CCRA) held that two classes of units, each class having different attributes, will not satisfy the condition in regulation 5102(1)(d) of the definition of "small business investment limited partnership," which requires the units of the partnership to be identical in all respects.

Standard Terms

The specific terms governing a venture fund will vary depending on the nature of the proposed activities and the identity of the target investors. However, some provisions are common to most such funds. Given the integral nature of these terms and their potential impact on the tax structure of these investments, it is necessary to have at least a basic understanding of them. An overview of these terms and a brief description of the common elements are set out below.

Capital Commitments

In the model depicted in figure 1, investment capital is raised by the issuance of units of both the Canadian and the US partnerships. On the basis of the targeted investments and the prevailing investment climate, the fund sponsor establishes a minimum and a maximum capital commitment target for the fund. Normally, a minimum commitment threshold is also imposed on each individual limited partner, although the general partner may reserve the right to accept commitments of a lesser amount.

The fund sponsor generally invests anywhere from 5 to 25 percent of the total capital commitments sought by the fund; selected employees of the fund sponsor, including the fund executives, generally invest up to 10 percent of the total commitments.

An initial closing of the fund offering occurs as soon as practicable after the date on which the general partner has raised the minimum capital commitments. If the maximum offering is not raised at the initial closing, subsequent closings may occur at the discretion of the general partner. Generally, the final closing takes place no later than 12 months after the initial closing.

Limited partners admitted at any subsequent closing are normally required to pay the fund an amount equal to the portion of their respective commitments that would have been drawn down had they been limited partners from the time of the initial closing, plus interest (usually bank prime plus some specified percentage) on their proportionate share of the original cost of any venture capital investments made before that date.

Term

The term of the fund is generally 7 to 10 years, but it may be extended at the discretion of the general partner. Normally, this is done by a simple majority vote of the limited partners. Some funds exclude the fund sponsor and any of its affiliates from the vote. (As discussed below, if qualified limited partnership status is sought for the fund, it is preferable not to include such exclusionary voting provisions.) Notwithstanding the set term, the limited partners usually have the right to terminate the fund by supra-majority vote at any time after the initial closing.

Capital Calls

Capital calls are made from time to time for a period of up to six years after the initial closing (this is referred to as “the commitment period”). The commitment period may be shortened by a vote of a specified number of the limited partners. Again, some funds exclude the fund sponsor and any of its affiliates from the vote. As noted above, it is preferable not to include such exclusionary voting if qualified limited partnership status is sought for the fund.

After the end of the commitment period, the limited partners are generally released from any further obligations with respect to their undrawn commitments, except to the extent necessary to cover the expenses of the fund, complete investments in respect of transactions that were in process as of the end of the commitment period, and make "follow-on" investments (that is, additional investments of capital in the same investee company). Normally, any follow-on investments must be made within a set period of years after the end of the commitment period and cannot exceed a specified percentage of the total commitments. A limited partner, however, is never obliged to make capital contributions in an amount in excess of its unfunded commitment.

Investments

The Canadian and US limited partnerships that make up the fund (and any other parallel investment entity created to facilitate investment) invest in all the venture capital investments proportionately (on the basis of their respective capital commitments) and on essentially the same terms and conditions (except as may be dictated by differences in legal structure). In some cases, the general partner may have the discretion to provide co-investment opportunities or representation privileges to certain limited partners—normally, the larger and more influential investors. For the reasons discussed below, as in the case of exclusionary voting, it is preferable to avoid such provisions in the qualified limited partnership context.

The fund primarily invests in equity and equity-related securities of private corporations. To facilitate the closing of transactions, the fund normally provides bridge financing when there is a high degree of confidence that the bridged securities can be refinanced. Passive transaction income related to making capital available (for example, commitment fees,[7] standby fees,[8] completion fees,[9] and guarantee fees) may also be generated. In the event that the fund does not have its contributed

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7 Normally, a commitment fee is charged in consideration for the conditional or firm undertaking to make capital available to an investee corporation. Generally, such a fee is earned whether or not the financing actually closes, and it is structured as a single payment that becomes due upon the signing of a commitment letter. The commitment fee can also be structured as a series of payments, the first of which becomes due upon the signing of a commitment letter; the remainder becomes due only if the investee corporation does not close.

8 When a closing is delayed beyond a predetermined date, a standby fee is also normally charged for making capital available for the extended period. In these cases, the fee is normally structured as a single payment that becomes due upon the firm's undertaking to make the capital available in such circumstances, or as a series of payments, one of which becomes due upon the firm's undertaking to make the capital available and another of which becomes due only at the time of closing.

9 Completion or closing fees are normally charged for the provision of capital when a transaction is closed.

capital fully invested in equity and bridged securities, any surplus contributed capital is temporarily invested in money market instruments.

Allocations and Distributions

The fund agreement normally contains detailed provisions concerning the capital account allocations and distributions to investors. Typically, the income or loss of the fund is allocated and distributed such that short-term investment income earned on contributed capital before it is initially invested is allocated to the limited partners pro rata to their contributed capital. Such income is distributed at least annually. Once invested, net income is allocated and distributed to the limited partners until a fixed preferred return is earned.

The preferred return ensures that the limited partners receive at least some minimum rate of return from the fund before the general partner is entitled to participate in profits. Its use has become commonplace owing to the high rate of return typically projected by the general partners that manage such funds. In effect, the preferred return ensures that the general partner shares in the profits of the fund only to the extent that the investments perform well. Indeed, if the preferred return is never met, the general partner will not be entitled to receive any profits from the fund. In this way, the preferred return functions as an incentive to the general partner to achieve the return projected by the fund.

Once the limited partners receive their preferred return, a "catch-up payment" (described below) is then allocated and distributed to the general partner. Thereafter, net income is allocated and distributed to the limited partners and to the general partner on the basis of some agreed-upon percentage. The general partner's percentage is referred to as a "carried interest" and represents the general partner's incentive to perform.

The catch-up payment ensures that the limited partners and the general partner receive their agreed-upon percentage of the net income, provided that the fund generates sufficient profits. The payment is triggered as soon as the fund has delivered the preferred return to the limited partners. Then distributions go to the general partner as a catch-up payment until it has received its share of profits proportionate to the limited partners' preferred return. Thereafter, distributions are again divided according to the fund's stated profit-sharing formula.

Consider, for example, a venture capital fund that gives the limited partners an 8 percent preferred return and the general partner a 20 percent carried interest. Initially, all distributions will go to the limited partners until they have recouped their contributed capital plus the 8 percent preferred return. Thereafter, all or most distributions will go to the general partner until it has received its catch-up payment—in this example, profits representing the ratio of 20 percent compared to the 80 percent paid as a preferred return to the limited partners. Thereafter, all distributions will again be divided according to the agreed-upon 80 percent-20 percent split between the limited partners and the general partner.

Net losses are generally allocated in accordance with the agreed-upon split in profits of the fund. Accordingly, if the limited partners are entitled to 80 percent of the profits and the general partner is entitled to 20 percent, losses will be allocated on the same proportionate basis.

Management Fee

The general partner is responsible for managing the fund and normally receives a management fee.[10] Initially, the management fee is a stated percentage (usually 2 percent) of the committed capital until the earlier of (1) the end of a stipulated period after the initial closing of the fund ("the management period"), and (2) the point at which a specified percentage of the capital has been invested or has been reserved for the investments and expenses of the fund. Thereafter, if the requisite percentage of capital has been invested or reserved for specified purposes and until the end of the management period, a stepped-down management fee is paid. From this point, the management fee is based on the aggregate cost basis of the investments held by the fund (to the extent that such investments have not been written off). After the end of the management period, the fee is even further stepped down in recognition of the fact that a less active management role is needed in identifying and managing the fund's assets.

The management fee is normally reduced by any transaction, directors', consulting, and closing fees paid by an investee corporation. Any breakup fees in connection with the fund's unconsummated transactions are also normally deducted. The offset is done in one of two ways: either the fund earns the fees and then directs them to the general partner in satisfaction of its management fee, or the general partner earns the fees directly and reduces the management fee by a corresponding amount. Normally, the second method is preferable; if the fund earns such fees directly and they are characterized as being income from business, some of the fund's investors could be negatively affected. This point is discussed in more detail below.

Default

Default provisions of some sort are also common. Normally, if a limited partner defaults in respect of its unfunded commitment, it may be subject to certain contractual remedies, including forfeiture of its interest in the partnership or a suspension of its distribution entitlements from the fund. The latter remedy should not be employed in the qualified limited partnership context.

Exclusions

Normally, all of the limited partners participate in each investment. However, if the participation of a limited partner in a particular investment could result in a breach of any law or regulation to which it is subject, the limited partner may be excused

10 In some cases, the general partner may enter into a management agreement whereby the services of an affiliate are engaged to provide management services to the fund. This is commonly done in situations where non-residents are involved and the safe harbour provisions of section 115.2 are being used to protect the non-resident investors from the imposition of Canadian tax.

from participation in the investment. Similarly, the general partner may exclude a limited partner from a particular investment if it determines that it could have any materially adverse affect on the fund, an investee corporation, or a future investment. If such an exclusion clause is triggered, the general partner may issue new capital calls to limited partners who are not excluded; no limited partner, however, is ever required to fund an amount in excess of its unfunded commitment. Like the default provisions that allow the suspension of distribution entitlements from the fund, these provisions should be avoided in the qualified limited partnership context. This point is discussed in more detail below.

Insurance

During the term of the fund, the partnership may obtain insurance by way of surety bond to cover any losses incurred as a result of gross negligence, wilful misconduct, or fraud on the part of the general partner, officers, employees, or agents of the partnership.

Clawback

Upon liquidation of the fund, the general partner is normally required to restore funds to the partnership (net of amounts necessary to cover taxes incurred by the general partner thereon) if and to the extent that it received a cumulative carried interest greater than its agreed-upon percentage, as finally determined. This amount normally takes the form of a capital contribution and is distributed among the limited partners as a return of capital. This clawback is normally guaranteed by the fund sponsor.

Jurisdiction of Formation

The choice of jurisdiction in which a venture capital fund is formed depends on the nature of the proposed activities and the degree of limited liability protection sought by the fund participants. Given the greater limited liability protection offered by some jurisdictions (for example, Delaware), the use of foreign legislation is often attractive, particularly to fund executives who normally invest as limited partners.

In Ontario, in contrast to some other provinces, the Limited Partnerships Act (LPA)[11] specifically deals with limited partnerships that are organized under the laws of a jurisdiction other than Ontario (defined in section 1 as "extra-provincial limited partnerships").

Like limited partnerships formed under the LPA, pursuant to section 25(1) of the LPA, extraprovincial or foreign partnerships are required to file a declaration containing prescribed information before they can carry on business in Ontario. The phrase "carry on business" is defined in section 25(1) of the LPA and, when combined with the definition of "business" in section 1, has a very broad meaning.

11 Limited Partnerships Act, RSO 1990, c. L.16, as amended (herein referred to as "the LPA").

Like Ontario partnerships, foreign partnerships that do not file the declaration are incapable of maintaining a proceeding in a court of Ontario in respect of the business carried on by the limited partnership, except by leave of the court. All members of the partnership are similarly incapable. However, no limited partner loses its limited liability only because the foreign partnership has not filed a declaration.

The LPA does not force its provisions regarding the limited liability of limited partners on foreign partnerships. In fact, section 27(2) states that "[t]he laws of the jurisdiction under which an extra-provincial limited partnership is organized govern its organization and internal affairs and the limited liability of its limited partners." The LPA, therefore, specifically recognizes that different limited liability protection may be afforded to the partners of a foreign partnership. Although the issue is not entirely free from doubt, it appears that in Ontario, at least, enhanced liability protection can be obtained through the use of foreign legislation.[12]

Characterization of Foreign Partnerships

If a partnership entity established under the laws of a foreign jurisdiction is contemplated (for either the main or the parallel fund), consideration must be given to how the entity will be treated for the purposes of the Act. To ensure that the flowthrough treatment normally accorded to partnerships will apply to the proposed entity, there must be a sufficient degree of comfort that the Canada Customs and Revenue Agency (CCRA) will accept that the proposed entity is in fact a partnership and not a corporation. Such an analysis may seem academic in the context of foreign jurisdictions such as the United States; however, in the light of recent issues raised with respect to entities governed by Delaware legislation, it warrants some analysis.

No Canadian jurisprudence specifically addresses how a foreign partnership should be characterized for Canadian tax purposes, and the Act contains no meaningful definition of "partnership" or "corporation."[13] Some guidance, however, can

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12 Saskatchewan, New Brunswick, and Prince Edward Island have provisions essentially identical to those set out in section 27(2) of the LPA. In British Columbia and the Yukon Territory, an extraprovincial limited partnership has rights, privileges, duties, restrictions, and liabilities that are the same as but no greater than those imposed on a limited partnership formed in the respective provinces. Therefore, it appears that the laws of the original jurisdiction and of British Columbia or the Yukon, as applicable, apply in determining the rights and liabilities of a limited partner of a foreign limited partnership carrying on business therein. The Northwest Territories, Nova Scotia, Alberta, and Newfoundland also provide for the registration of an extraprovincial partnership. Although the matter is not entirely clear, it appears that the laws of both the original jurisdiction and the relevant province apply in determining the rights and liabilities of a limited partner. The provisions of the Quebec Civil Code relating to contracts of partnership and of association do not contain the concept of an extraprovincial partnership; Manitoba legislation also does not appear to deal with such partnerships.

13 Subsection 102(1) defines the term "Canadian partnership" simply as a partnership, all of the members of which are resident in Canada; subsection 248(1) defines the term "corporation" to include an incorporated company.

be obtained from the definition of "corporation" in section 35(1) of the Interpretation Act,[14] which applies to all federal statutes, including the Act.

Section 35(1) of the Interpretation Act provides that a corporation "does not include a partnership that is considered to be a separate legal entity under provincial law." The definition is worded very broadly, and by its express terms is not limited to partnerships "formed" under provincial law. Therefore, the definition appears to apply to partnerships formed under foreign legislation, provided that such partnerships are considered separate legal entities under provincial law. Most but not all of the provinces and territories specifically recognize the existence of foreign-based partnerships (for example, see the limited partnership legislation in Quebec and Manitoba).[15]

The Interpretation Act's definition of "corporation" appears somewhat inconsistent with the CCRA's. In *Interpretation Bulletin* IT-343R, the CCRA states:

> A corporation is an entity created by law having a legal personality and existence separate and distinct from the personality and existence of those who caused its creation or those who own it. A corporation possesses its own capacity to acquire rights and to assume liabilities, and any rights acquired or liabilities assumed by it are not the rights or liabilities of those who control or own it. *As long as an entity has such separate identity and existence, the Department will consider such entity to be a corporation even though under some circumstances or for some purposes the law may ignore some facet of its separate existence or identity* [emphasis added].[16]

If paragraph 2 of IT-343R were read literally, any separate legal entity formed under foreign law would be characterized as a corporation for purposes of the Act.[17] This is inconsistent not only with domestic legislation but also with the generally accepted practice of the OECD. For example, in the OECD study on partnerships, in respect of which Canada made no reservations, the following general guideline is provided:

> In most cases, the similarities between the legal systems of the Member countries will be sufficient to ensure that what is a company or a partnership in the country where it has been established is recognized as such, for tax purposes, in other countries.[18]

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14 RSC 1985, c. I-21, as amended.

15 See supra note 12.

16 *Interpretation Bulletin* IT-343R, "Meaning of the Term Corporation," September 26, 1977, paragraph 2.

17 The italicized portion of paragraph 2 of IT-343R refers to "*such* separate identity and existence" (that is, the separate identity and existence described previously in the paragraph) and thus could be read as intending to include *any* separate legal entity. However, given that most separate legal entities formed under foreign law would have the separate identity and existence previously described in paragraph 2, such status would be determinative of characterizing the entity as a corporation if the provision was read literally.

18 Organisation for Economic Co-operation and Development, *The Application of the OECD Model Tax Convention to Partnerships* (Paris: OECD, 1999), paragraph 17.

The OECD study appears to suggest that where a partnership formed under foreign legislation is characterized as a partnership and not as a corporation, Canada should respect that characterization.

In the context of US partnerships (and, more specifically, Delaware limited partnerships), the CCRA has generally applied the guidelines in IT-343R more narrowly and respected such partnerships as partnerships. For example, in determining non-resident withholding rates and in issuing section 116 certificates, it has consistently looked through US partnerships and determined treaty entitlements on the basis of the members' identity. Notwithstanding this longstanding practice, in a private interpretation dated July 25, 2000, the CCRA concluded that a partnership formed under the Delaware Revised Uniform Partnership Act (DRUPA) was not a partnership but a corporation for Canadian tax purposes. After considerable criticism by the tax community, and in consultation with the Department of Justice, the CCRA publicly reversed this interpretation and reinstated its former view.[19] In so doing, the CCRA stated that the proper approach in classifying a foreign entity is to compare the attributes of the entity to the attributes of a Canadian partnership and of a Canadian corporation. If, at common law, the attributes of the foreign entity more closely resemble those of a Canadian general partnership, the foreign entity should be treated as a partnership for Canadian tax purposes. More importantly, it confirmed that the existence of a "separate legal entity" clause in the foreign legislation will not, in and of itself, preclude the entity from being considered a partnership for the purposes of the Act. As noted above, this is consistent with both the Interpretation Act and the approach taken by the OECD.

The CCRA's revised approach is helpful and is not likely to create characterization issues with respect to US partnerships. Nevertheless, it remains to be seen whether partnerships formed under less well-known legislation will be respected.[20] If a partnership formed under legislation other than that of the United States is contemplated, care should be taken to ensure that the partnership status of the entity will be respected on the basis of the CCRA's new approach.

Finally, although characterization issues may not be relevant (depending on the foreign legislation chosen), compliance issues can arise even in the most familiar of jurisdictions. For example, if a partnership is formed under the DRUPA, the parties should be aware of the potential US filing obligations that may result. Accordingly, care should be taken when using foreign legislation to form either the main fund or a parallel fund.

19 See CCRA document no. 2000-0056715, November 28, 2000, and *Income Tax Technical News* no. 20, June 14, 2001. This position was reaffirmed in draft *Income Tax Technical News* no. 25, October 30, 2002.

20 For example, see CCRA document no. 9624595, July 30, 1996; CCRA document no. 95-6134, September 15, 1988; and CCRA document no. rrrr75, May 11, 1983. From conversations with CCRA officials, it appears that these interpretations continue to be valid notwithstanding the revised approach to classification prompted by the DRUPA interpretation.

FOREIGN PROPERTY ISSUES

As noted above, the greatest challenge faced by venture funds structured as limited partnerships is the fact that such investments are generally "foreign property" for tax purposes.[21] Normally, by virtue of paragraph 206(1)(i), an investment in a limited partnership, other than a prescribed partnership, is treated as "foreign property." This is the case notwithstanding that the partnership may be governed by Canadian law, hold only Canadian assets, and have only Canadian-resident partners.

Part XI of the Act imposes a penalty tax of 1 percent per month on excessive holdings of foreign property by certain investors (registered pension plans, registered retirement savings plans, deferred profit-sharing plans, registered retirement income funds, and certain other tax-exempt entities). The incidence of the tax is determined by comparing, at the end of a given month, the total cost amount (for example, the acquisition cost) of the entity's foreign property to the aggregate cost amount of all its property. The tax applies when, at the end of a given month, the aggregate cost amount of all foreign property held by the entity exceeds 30 percent of the aggregate cost amount of all property held by the entity.[22]

Only three types of partnerships have been prescribed for the purposes of paragraph 206(1)(i): designated limited partnerships, small businesses investment limited partnerships, and qualified limited partnerships.[23] Designated limited partnerships must have interests that were listed on a prescribed stock exchange before 1999, and are therefore a form of grandfathered exclusion.[24] As a result, such partnerships cannot be used to avoid foreign property classification with respect to new funds. Small business investment limited partnerships and qualified limited partnerships are very similar, except in one important respect. The only activity permitted to a small business investment limited partnership is the investing of its funds in certain prescribed properties. The types of investments that a small business investment limited partnership can make include

1. "small business securities"[25] where the small business investment limited partnership was the first person other than a broker to have acquired the securities and has owned the securities continuously since their acquisition;

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21 Unless such investments are listed, they are also not "qualified investments" for registered retirement savings plans, deferred profit-sharing plans, registered retirement income funds, or registered education savings plans. However, given that registered pension plans are normally the target investors, this does not pose a significant challenge in the marketing of these funds.

22 Subsection 206(2).

23 Regulation 5000(1.1).

24 Paragraph (b) of the definition of "designated limited partnership" in regulation 5000(7).

25 A "small business security" is defined in regulation 5102(1)(f) to mean, in general terms, a share, debt, or option of an "eligible corporation." An "eligible corporation" is defined in regulation 5100(1) as a taxable Canadian corporation all or substantially all of whose properties are used in a "qualifying active business" or in share investments or debt obligations of related eligible corporations. To be a qualifying business, the business must be carried on primarily in

2. property described in subparagraphs (f)(i) to (iv) of the definition of "qualified limited partnership" in regulation 5000(7) (see the discussion below), which includes shares of corporations, rights to acquire such shares, and debt of corporations;
3. specified properties (which include Canadian dollars, debt that is issued or guaranteed by the federal, a provincial, or a municipal government in Canada, debt issued by corporations listed on a prescribed stock exchange in Canada, and certain guaranteed investment certificates); and
4. any combination of the properties described in items 1 to 3 above.

Given that the category of prescribed investments in item 2 above parallels the types of investments that a qualified limited partnership can make, at first glance it may appear that the investment scope of a small business investment limited partnership is similar to that of a qualified limited partnership. However, unlike a qualified limited partnership, a small business investment limited partnership must meet certain prescribed minimum investment levels in "small business securities."[26] It is this forced investment content in small business securities that superimposes a second and much more restrictive requirement on a partnership that seeks small business investment limited partnership status. In fact, it is because of this restrictive investment requirement that the venture capital industry lobbied for a more flexible form of vehicle to make venture capital investments. This gave rise to the addition of the qualified limited partnership rules in 1986.

Given the limitations of both the designated limited partnership and the small business investment limited partnership structures, a qualified limited partnership is generally the most viable form of prescribed partnership for venture capital investments. The conditions necessary to establish a fund as a qualified limited partnership are discussed below.

Qualified Limited Partnership

A qualified limited partnership is defined in regulation 5000(7) as a limited partnership that "at all times after it is formed and before the particular time" complied with the following conditions:

Canada. Certain businesses, such as those whose principal purpose is to derive income from property, are excluded. In addition, the total cost of all shares, options, rights, and debt of the relevant corporation and all associated corporations owned by the small business investment limited partnership cannot exceed $10,000,000, and the total consolidated assets of the relevant corporation and associated corporations cannot exceed $15,000,000.

26 By virtue of the requirement in regulation 5102(1)(g), the small business investment limited partnership is required to comply with certain prescribed minimum investment levels in "small business securities." Within 12 months of the issue of its units, 25 percent of the net issue proceeds must be invested in small business securities; within 24 months, 50 percent; and within 36 months, 75 percent. If the partnership has disposed of an investment, it has 90 days to reinvest the funds.

1. it had only one general partner;
2. the share of the general partner in any income of the partnership from any source for any period was the same as its share in any income or loss from any other source in the period (an exception is made for income from "specified properties," which are defined to include cash, near cash, certain government and corporate bonds, and certain investment certificates);
3. the share of the general partner in any income or loss for any period was not less than its share for a preceding period;
4. no limited partner or group of limited partners that do not deal with each other at arm's length held more than 30 percent of the units (as is discussed in more detail below, proposed changes to regulation 5000(7) would modify this requirement);
5. the interests of the limited partners were described by reference to units of the partnership that were identical in all respects (as is discussed in more detail below, the February 18, 2003 federal budget proposes to relax this requirement in specified circumstances);
6. the only undertaking of the limited partnership was the investing of its funds, and its investments consisted solely of shares of corporations (other than flowthrough shares), rights or warrants to acquire shares, put or call options in respect of shares, debt obligations of corporations, and "specified properties";
7. a subsection 97(2) tax-deferred rollover of property to the partnership has not been made;
8. the partnership has not borrowed money except for the purpose of earning income from its investments, and the amount of such borrowings at any time did not exceed 20 percent of its capital; and
9. the partnership did not exceed its 30 percent foreign property limit.

Subject to the foreign property limitation proposed in the February 18, 2003 federal budget, the foregoing requirements must be met "at all times" after the partnership was formed and "before the particular time." Accordingly, on its face, the definition is retrospective. The "at all times" requirement not only has implications from a monitoring perspective, but also creates interpretational issues with respect to the meaning of certain of the qualified limited partnership conditions (for example, the requirement that all units be identical). The requirement also means that any inadvertent violation cannot be remedied: it puts the fund forever "offside" of the stated requirements. These points are discussed in more detail below.

A qualified limited partnership need not be a "Canadian partnership" (defined in subsection 102(1) as a partnership all of the members of which are resident in Canada). A non-resident can therefore invest in such a partnership without affecting its qualified limited partnership status.[27] A qualified limited partnership does not

27 For both compliance and certain tax mitigation reasons, a separate foreign investment vehicle is normally used for non-residents. However, in circumstances where the use of such an additional vehicle cannot be justified, the fact that a qualified limited partnership need not be a

have to be formed under Canadian legislation. Accordingly, as discussed above, it is possible to use foreign legislation to form such a partnership.

General Partner

Many venture capital funds obtain qualified limited partnership status through the use of a two-tier partnership structure. The fund is structured as a limited partnership with a general partner that is also a limited partnership. Normally, the general partner of the top-tier operating partnership is a newly incorporated corporation wholly owned by the fund sponsor, and the limited partners are the fund executives—either directly or indirectly, through holding companies or trusts. When the fund is structured in this manner, the carried interest of the executive group can be channelled to the general partner of the top-tier partnership and on to the fund executives as a limited partner allocation. Accessing the carried interest through a second limited partnership permits the executive group to take the filing position that the carried interest is on capital account. If the carried interest was not accessed through such an arrangement, but merely paid out in the form of a bonus or similar payment, it would clearly be on income account. The two-tier structure therefore provides a more favourable basis for capital gains treatment.

One issue that arises in the context of the two-tier partnership structure is whether the requirement in regulation 5000(7)(a) that there be only one general partner is met. As noted above, under this model the general partner of the fund partnership is itself a limited partnership.

On the entity theory (which holds that a partnership is not a separate legal person but nevertheless attributes to the partnership certain characteristics as if it were an entity separate and apart from its partners), the partnership is considered an entity that is the owner of property (an interest in the fund). The concept of "partnership property" in which no one partner can transfer rights in any specific partnership property connotes, according to this theory, ownership of such property by the partnership as an entity distinct from its partners. It is the partnership that owns the property; the partners own a partnership interest but do not hold legal ownership in the partnership property per se. On this theory, a general partner that is itself a limited partnership is considered one single entity for purposes of regulation 5000(7)(a).

On the aggregate theory (which holds that a partnership is merely a relationship between persons carrying on business in common and is not itself a legal entity), the partnership is not considered an entity that is the owner of property (an interest in the fund). Rather, each partner is considered to own an undivided interest in the partnership property (the fund interest). On this theory, what is called "partnership property" under partnership law is merely property dedicated to the business of the partnership; the term does not imply ownership of that property by the partnership. As a result, it could be argued that a general partner that was itself a limited

Canadian partnership permits the use of a single partnership vehicle for both resident and non-resident investors. This topic is discussed in more detail below.

partnership could be considered not one general partner for purposes of regulation 5000(7)(a), but rather an aggregation of its constituent members.

Support for both of these theories can be found in case law and legal commentary. The CCRA appears to be inconsistent in its application of these theories to various provisions of the Act. Nevertheless, on the basis of a recent ruling in which a two-tier partnership structure was held to comply with the qualified limited partnership requirements, it appears that such a structure satisfies the conditions in regulation 5000(7)(a).[28]

Income or Loss of General Partner

In the typical venture fund format, net income is allocated to the limited partners until a fixed preferential return is earned. A catch-up payment is then allocated to the general partner. Thereafter, the limited partners and the general partner share income in an agreed-upon percentage. Does such sharing of income satisfy the conditions in regulations 5000(7)(b) and (c)? Regulation 5000(7)(b) requires the share of the general partner in any income of the partnership from any source in any place for any period to be the same as its share in the income from the same source in other places and from other sources, in losses from any source, and in capital gains and capital losses. Regulation 5000(7)(c) requires the share of the general partner in any income or loss for any period to be not less than its share of income or loss for any preceding period.

In the typical venture fund structure discussed above, the share of the general partner in any income of the fund from any source for any period is the same as its share in the income from other sources, in losses from any source, and in capital gains and losses. With the exception of short-term investment income earned on contributed capital before it is initially invested, the general partner's entitlement to income and loss is fixed by formula, which does not vary from source to source. The disproportionate sharing of income from short-term investments is permitted by the exclusion in regulation 5000(7)(b) in respect of "specified properties" (cash, near cash, certain bonds, and investment certificates). As noted above, the share of the general partner in income from such sources may be less than its share of income from other sources. Accordingly, pending the investment of contributed capital, fund investors can be paid interest without jeopardizing the "equal sharing of income" requirement in regulation 5000(7)(b). This is significant in the venture capital context because it may be a long time before the initial contributed capital is invested.

The requirement that the share of the general partner in any income or loss for any period be not less than its share of income or loss for a preceding period also is arguably met by most venture fund structures. Although the amount to which the general partner is entitled may vary depending on the profitability of the partnership, the general partner's entitlement is fixed by formula and cannot exceed the

28 See CCRA document no. 9911433, May 25, 2000.

relevant percentage; thus, the share of the general partner in any income or loss for any period can never decrease. The presence of a catch-up payment should not matter, notwithstanding that it may result in a temporary fluctuation in the amount that the general partner is entitled to receive in "good" and "bad" years. Although the legislation is not entirely clear on this point, the CCRA has tacitly accepted this interpretation of regulation 5000(7)(c) and has ruled that a limited partnership structured with a catch-up payment mechanism complies with the conditions of regulation 5000(7)(c).[29]

From an economic perspective, similar arguments can be made in support of the clawback, which requires the general partner to restore funds to the partnership if and to the extent that it received a cumulative carried interest greater than its agreed-upon percentage. From a legal perspective, such amounts are normally contributed as capital upon the liquidation of the fund. Therefore, these amounts should not affect the income or loss analysis of the general partner unless the CCRA views the contribution as a disguised attempt to circumvent regulations 5000(7)(b) and (c). Although there is no specific ruling on point (and thus no complete certainty), given the economic parallels with the catch-up payment (which the CCRA has agreed is acceptable in this context), it is not likely that the department will find such transactions offensive.[30]

Notwithstanding the CCRA's tacit acceptance of temporary fluctuations in the general partner's share of the partnership's income, the investment community lobbied the Department of Finance to clarify the legislation in this regard. In response to these lobbying efforts, the February 18, 2003 federal budget proposed changes to the qualified limited partnership rules to deal with this and other related qualified limited partnership issues. Although no legislation has been issued to implement these changes, the 2003 budget proposals indicate that, for 2003 and subsequent taxation years, the qualified limited partnership rules will be modified to provide that a partnership will not lose its qualified limited partnership status solely because of a temporary fluctuation in the general partner's share of the partnership's income as a result of the limited partners having priority in the ordering of distributions. Although this interpretation could have been taken from the existing legislation (and has, in fact, been sanctioned by an advance income tax ruling), it is a welcome clarification of the rules. Given the nature of the change,

29 Ibid. See also CCRA document no. 9711923, October 3, 1997. For example, if there are sufficient profits in year 1, the limited partners and the general partner will receive their preferential return and the carried interest, respectively. If year 2 does not generate sufficient profits, the general partner may not be entitled to any amount from the partnership. On a strict reading of regulation 5000(7)(c), the general partner's share of income for year 2 is less than its share in the preceding year; however, the CCRA has not interpreted the provision in this manner.

30 The only caveat in this regard is the CCRA's recent attempts to distance itself from some of its published positions in respect of the identical unit issue. Although its concerns appear to be restricted to this condition, it is not clear whether a more general review of the qualified limited partnership requirements is being made.

however, it is surprising that it was made for 2003 and subsequent taxation years and not retrospectively to 1986 (the year which the rules were first enacted).

The 30 Percent Test

Currently, regulation 5000(7)(e) requires that no limited partner or group of limited partners who do not deal with each other at arm's length hold more than 30 percent of the units of the fund. This 30 percent ownership limitation has made it difficult for partnerships to satisfy the qualified limited partnership requirements both initially[31] and on an ongoing basis.[32]

To facilitate the use of qualified limited partnerships by the investment community, the December 10, 2001 federal budget proposed the elimination of the 30 percent ownership requirement. The draft legislation released February 5, 2002[33] would replace the 30 percent test with a rule that provides that if any person or non-arm's-length group of persons owns more than 30 percent of the units of a qualified limited partnership, then a specified portion of each unit will be prescribed not to be foreign property based on the underlying cost amount of non-foreign property versus foreign property.

The 2002 draft legislation implements these changes by repealing regulation 5000(7)(e) (which contains the 30 percent ownership limitation) and regulation 5000(1.1)(c) (which provides that an interest of a limited partner in a qualified limited partnership is not foreign property) and replacing them with new regulations 5000(1.3) to (1.5) (which describe how a limited partner's interest in a qualified limited partnership is to be treated for foreign property purposes).

New regulation 5000(1.3) contains the substantive rule for determining the extent to which an interest in a qualified limited partnership would be foreign property under the 2002 draft legislation. Specifically, it provides that the specified portion (as defined in regulation 5000(1.4)) of a qualified limited partnership unit that is held at any time by a specified partner (as defined in regulation 5000(1.5)) is prescribed not to be foreign property of the specified partner at that time.

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31 For example, see CCRA document no. 9629875, October 24, 1996, wherein the CCRA took the position that a limited partnership with a single initial limited partner could not meet the 30 percent test.

32 The requirement that a partnership meet the 30 percent requirement "at all times after it was formed" results in a need to continually track the level of ownership of the fund units. This means that any investment or proposed investment by any person who is not at arm's length with an existing investor must be carefully monitored. It also requires careful consideration of any voting trust arrangement whereby shares held by a number of limited partners are "pooled" together for administration by a single trustee. This could be of particular concern where that trustee is related to an affiliate of the fund sponsor that itself owns an interest in the partnership.

33 Canada, Department of Finance, "Draft Income Tax Regulations and Explanatory Notes," in *Explanatory Notes Relating to the Air Travellers Security Charge and to Income Tax* (Ottawa: Department of Finance, February 2002), appendix C (herein referred to as "the 2002 draft legislation"). Proposed regulations to implement these changes were released on May 17, 2003. Section 3 of the proposed regulatory text dealing with new regulations 5000(1.3) to (1.5) is to apply to taxation years after 2001.

New regulation 5000(1.4) defines the specified portion of a qualified limited partnership unit. Specifically, regulation 5000(1.4)(a) defines the specified portion to be the whole of the limited partnership unit if the total number of limited partnership units held at that time by the specified partner and by other specified partners not dealing at arm's length with the specified partner does not exceed 30 percent of the total number of limited partnership units held at that time by all specified partners. If the 30 percent ownership threshold is exceeded, regulation 5000(1.4)(b) defines the specified portion to be that portion of the limited partnership unit that the total cost amount at that time of all the qualified limited partnership's non-foreign property is of the total cost amount of all its property. Accordingly, if a qualified limited partnership had no foreign property, the specified portion will be the whole unit, even if the 30 percent ownership threshold is exceeded.

Where only a portion of a qualified limited partnership unit held by a specified partner is prescribed not to be foreign property, the remainder of the limited partnership unit is foreign property. In this case, the cost amount of the limited partnership unit is allocated between the part that is foreign property and the part that is not, in the same proportion as the limited partnership unit itself is treated as foreign and non-foreign property.

In essence, regulation 5000(1.4)(a) maintains the status quo by providing that units held by a tax-exempt investor will continue to be excluded from treatment as foreign property, provided that the tax-exempt investor (either alone or as part of a non-arm's-length group) does not own more than 30 percent of the units of the qualified limited partnership. Regulation 5000(1.4)(b) implements the substantive change whereby, if a tax-exempt investor owns more than 30 percent of the units (again, either alone or as part of a non-arm's-length group), the units held by the tax-exempt investor will be treated as foreign property in the same proportion as the foreign property held by the qualified limited partnership. Presumably, a tax-exempt that exceeds the 30 percent limit may subsequently reduce its investment to below 30 percent, and thereafter avoid foreign property treatment.

The explanatory notes to the 2002 draft legislation give the following example. If a tax-exempt owned 50 percent of the units of a qualified limited partnership, and if 20 percent of the cost amount of the partnership's property consisted of foreign property, then 20 percent of the cost amount of the tax-exempt investor's units would be treated as the cost amount of foreign property and 80 percent would be treated as the cost amount of non-foreign property. If the qualified limited partnership held no foreign property, the entire unit would be excluded from foreign property treatment irrespective of the fact that the tax-exempt held more than 30 percent of the units.

Regulation 5000(1.4)(b) looks to the cost amount of a qualified limited partnership's property at any time that a unit is held by the specified partner. Thus, a specified portion of the unit that is prescribed not to be foreign property will change as the ratio of the cost amount of the qualified limited partnership's foreign property to the cost amount of its non-foreign property changes. In the example given above, if the qualified limited partnership acquired additional foreign property and the cost amount thereof increased to 30 percent of the cost amount of all its property, the foreign property content of the tax-exempt investor would be similarly increased. Specifically, the portion of each limited partnership unit held by the tax-exempt investor that was foreign property would increase to 30 percent, and the portion that was prescribed not to be foreign property would decrease to 70 percent.

The fact that the determination of the specified portion is measured on an ongoing basis will not normally be problematic. This is because the determination that is usually relevant is the one that is done at the end of each month. While this is true for most taxpayers subject to the foreign property rules, it may pose difficulties for investors that are mutual fund trusts or corporations, but not registered investments. Pursuant to regulation 5000(1)(e), such investors cannot exceed the foreign property limits at *any time* during the relevant period for the particular month, not merely at month's end.[34]

As noted above, the rules that deem all or a portion of a limited partner's interest in a qualified limited partnership not to be foreign property apply only to "specified partners." Generally, pursuant to regulation 5000(1.5), any person or partnership that holds a qualified limited partnership unit is a specified partner unless the limited partner is also the general partner or is a qualified trust or qualified corporation to which the lookthrough rule in subsection 259(1) applies.

The exclusion of a general partner from the definition of "specified partner" is relevant in two respects. First, it means that any interest of the general partner in a qualified limited partnership (including an interest in the limited units thereof) is treated entirely as foreign property. This is a change from the current legislation, which exempts all units (including those held by a general partner) from foreign property classification if the qualified limited partnership requirements are met. Although this is an issue that should be considered in structuring a venture fund, it should not normally pose difficulties given that the general partner is usually not an entity subject to the foreign property rules.

Second, the exclusion of the general partner from "specified partner" status means that any qualified limited partnership units held by the general partner are disregarded for the purposes of the new 30 percent rule. Thus, even though the general partner may be dealing not at arm's length with a specified partner, the units held by the general partner are ignored in determining the total number of units held by the specified partner as part of a non-arm's-length group.[35]

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34 The term "relevant period for the particular month" is defined in regulation 5000(7). For months that fall during the fund's first taxation year, the relevant period is the first taxation year of the fund; for other months, the relevant period is the most recent taxation year of the fund ending before the end of the particular month. Accordingly, if a fund exceeds the foreign property limit at any time during its first taxation year (and is not a registered investment), its shares will be foreign property at least for months that end in its first two taxation years.

35 On the surface, the exclusion of the general partner from specified partner status appears to be helpful in avoiding the 30 percent limitation. However, any qualified limited partnership units held by the general partner are also ignored in determining the total number of units held by specified partners. The current wording of regulation 5000(7)(e) is not entirely clear in this

The exclusion in regulation 5000(1.5)(a) should be carefully considered in the structuring of a qualified limited partnership. An example of the effect of the general partner exclusion on the ownership thresholds of other specified partners is illustrated in example 3 of the explanatory notes to the 2002 draft legislation.[36] A qualified limited partnership has three limited partners (A, B, and C). All the partners deal with each other at arm's length. Partners A and B are specified partners and each hold 50 qualified limited partnership units. Partner C, which is the general partner (and therefore not a specified partner), holds 100 qualified limited partnership units. If partners A, B, and C were all specified partners, partners A and B would not exceed the 30 percent ownership threshold because each of them would hold only 25 percent of the total number of units held by all of the specified partners (50/200). Partner C, on the other hand, would hold 50 percent of the total number of units (100/200), and therefore would exceed the 30 percent limit.

However, when partner C is the general partner (and therefore not a specified partner), the ownership levels of partners A and B increase significantly. The result is that partners A and B each hold half of the qualified limited partnership units held by all of the specified partners (50/100), and the threshold is exceeded for both. The qualified limited partnership units held by partner C are treated, in their entirety, as foreign property.

The exclusion from the definition of "specified partner" of qualified trusts or qualified corporations to which the lookthrough rule in subsection 259(1) applies reflects the fact that the entities that have an interest in such trusts or corporations are themselves deemed to be specified partners of the qualified limited partnership.[37] The exclusion therefore ensures that there is no double counting of limited partnership interests in determining whether the 30 percent ownership threshold has been exceeded.

Identical Units

Subject to the 2003 budget proposals, for a partnership to constitute a qualified limited partnership, all of the units of the partnership must be described by reference to units that are identical in all respects.[38] On the surface, this appears to be a

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regard. This is because although regulation 5000(7)(e)(i) deems the general partner "not to hold any unit of the partnership as a limited partner," the provision does not go on to provide that such units are deemed not to exist for other purposes of the 30 percent test. Under the current rules, there is no concept of a "specified partner" (which effectively disregards the existence of units held by a general partner). Arguably, therefore, although the general partner's holdings are ignored in determining whether it or a limited partner that is at arm's length with the general partner meets the 30 percent limitation, the units are not ignored for other purposes of the test.

36 Supra note 33.

37 Proposed new regulation 5000(1.6).

38 Currently, the requirement in regulation 5000(7)(d) that the units held by the limited partners must be identical in all respects reads as follows: "The interest of the limited partners were described by reference to units of the partnership that were identical in all respects." Although the wording of this provision will be slightly changed by the 2002 draft legislation, the change

relatively simple requirement. In fact, it has proved to be the most serious stumbling block in classifying a partnership as a qualified limited partnership.

Phrasing identical to that in the regulation 5000(7)(d) definition of "qualified limited partnership" appears in regulation 5102(1)(d), which deals with "a small business investment limited partnership." No other similar references appear in the context of partnerships.

In the context of trusts, a phrase similar to that used in regulation 5000(7)(d) (which requires that units be identical to one another) appears in paragraph (b) of the definition of "qualified trust" in subsection 259(5) and in regulation 5103(1)(b). The requirement that the interest of a beneficiary be described by reference to units also appears in subsection 108(2) and paragraph (c) of the definition of "exempt trust" in section 233.2.

There is no jurisprudence with respect to the definition of "qualified limited partnership" in regulation 5000(7)(d). With the exception of one recent ruling (discussed below), no other CCRA positions or pronouncements deal specifically with this requirement. There also appears to be little in the way of commentary or technical notes clarifying the concern the drafters may have had in requiring the interests of the limited partners to be described by reference to units that are identical in all respects. From conversations with the CCRA, it appears that the primary purpose of the requirement is to ensure that income of a qualified limited partnership is not streamed to its members (that is, with tax preference items such as capital gains going to taxable investors and non-preference items such as interest going to tax-exempt investors).

In the context of trusts, there is some limited commentary relating to the purpose behind similar provisions. For example, in a technical interpretation dated January 13, 1994,[39] the CCRA considered the definition of a "qualified trust" in subsection 259(5) and in particular paragraph (b), which provided at that time that "all of the interests of the beneficiaries thereunder at that time are described by reference to units of the trust all of which are at that time identical to each other." The CCRA stated:

> It is our understanding that *the purpose of this provision is to ensure that the section only applies to trusts where all of the interests of all of the beneficiaries of the trust are identical in every respect except to the extent the beneficiaries hold different proportionate interests in the*

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appears merely to align the provision with the wording of other substantive amendments. The proposed wording of regulation 5000(7)(d) is as follows: "The interest of the limited partners were described by reference to units (in this section referred to as 'limited units') of the partnership that were identical in all respects to each other." As can been seen from the proposed definition, the only change is the insertion of the defining phrase "(in this section referred to as 'limited units')" and the addition of the words "to each other" after the requirement that the units must be "identical in all respects." In the explanatory notes to the 2002 draft legislation, no reference is made to the purpose of the revised wording. This reinforces the view that the change is grammatical and not substantive in nature. As discussed below, the 2003 budget proposals propose to relax the identical unit requirement to accommodate differences in units that do not affect the share or nature of the partnership's income or losses allocated among the limited partners.

39 CCRA document no. 9336145, January 13, 1994.

> *trust*. The section does not define a unit. However, it does provide that a unit must be capable of describing all of the interests of the trust and not merely the interests of the beneficiaries in the income of the trust. Therefore, if each and every interest of each beneficiary can be described by reference to a unit of money it could qualify as a unit for the purposes of this section. This would be a question of fact [emphasis added].

Although the foregoing interpretation is of limited assistance in assessing whether units are identical, it is helpful in determining that a unit to which such a test can be applied actually exists. This has particular relevance in the venture fund context. In many such funds, the income or loss of the partnership is allocated and distributed on the basis of the limited partners' capital accounts. The limited partners' capital accounts are themselves based on the partners' capital contributions. Accordingly, in these types of arrangements, each respective limited partner's proportionate interest in the partnership (and the resulting proportionate share of the partnership's income or loss) is calculated on the basis of the ratio of the limited partner's capital contribution to all the partners' capital contributions to the partnership. This method is similar to the dollar-allocation method sanctioned by the CCRA with respect to "qualified trusts" in the January 13, 1994 technical interpretation. It is also a method specifically approved of by the CCRA in the context of a qualified limited partnership ruling.[40]

It is clear that interests in a partnership that are described by reference to a unit of money are "units" for the purposes of regulation 5000(7)(d). It is less clear, however, whether such units are identical in all respects if the provisions typically found in most venture fund agreements are present.

For example, from discussions with the CCRA, it appears that the department might take issue with the typical venture fund provisions dealing with suspension of distribution entitlements on default, the exception or exclusion of investors if participation in a particular investment could result in a breach of any law or regulation, board or committee representation, and co-investment rights. Similar concerns may arise with respect to provisions dealing with limitation of voting rights, whereby the sponsor and any of its affiliates are excluded from voting in certain potential conflict circumstances. Although the CCRA has issued a favourable ruling on the identical unit issue in the context of a qualified limited partnership that contained at least some of the above types of provisions, it has retreated from this ruling and re-examined its position.[41] As discussed below, in the context of a

40 Supra note 28.

41 The ruling as originally given (see CCRA document no. 2000-0006283, July 18, 2000), provided as follows: "The terms of the Draft Agreement will not cause the Partnership to contravene the condition described in paragraph 5000(7)(d) of the definition of 'qualified limited partnership' that the interests of limited partners are described by reference to units of the partnership that are identical in all respects." As discussed below, this ruling has been amended to deal solely with the exclusion provision as set out in the draft agreement.

The CCRA's concerns with respect to the identical unit requirement in regulation 5000(7)(d) may be related to recent technical interpretations issued in other contexts. When typical exclusion provision, the CCRA has adopted a more practical approach in dealing with the identical unit issue. However, this type of provision will continue to cause problems should it ever be exercised. It is hoped that the Department of Finance will reassess its position and consider expanding the relief proposed in the 2003 federal budget along the lines discussed below.

Apparently, the CCRA's concerns with the default or exclusion provisions described above are based on the potential differentiation among investors that may result if one of these types of provisions is triggered. For example, in the context of a typical default provision, if an investor's right to distributions is suspended, it is the CCRA's view that such investor is treated differently and thus cannot be considered to have a unit that is identical in all respects to a unit held by a non-defaulting investor. Similarly, if an investor is excepted or excluded from an investment, that investor will not normally be entitled to any economic returns from and is shielded from any economic detriment attributable to the fund's participation in that investment. Accordingly, the investor will experience different economic consequences

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the ruling discussed above was first issued, there were no other CCRA pronouncements on point (other than the technical interpretations dealing with the "unit" issue in the context of the dollar allocation method applicable to "qualified trusts"). Since that time, the CCRA has revisited the identical unit issue in the small business investment limited partnership and qualified trust contexts. Unfortunately, those interpretations do not provide any meaningful analysis of the identical unit requirement or the factors relevant in determining whether it has been met.

For example, in CCRA document no. 1999-0007237, May 11, 2000, the CCRA considered whether a small business investment limited partnership with two classes of units, the units of each class being identical in all respects by class but the attributes of one class being different from the other, satisfied the condition in regulation 5102(1)(d) that requires all the units to be identical in all respects. Not surprisingly, the CCRA concluded that the partnership would not satisfy this condition on these facts.

In the trust context, the CCRA was asked whether units that are entitled to receive on redemption, and as a reduction of what otherwise would form part of the proceeds of redemption, any income generated by a sale of a trust asset to fund the redemption (to the exclusion of non-redeeming unitholders) satisfied the condition in paragraph 259(5)(b) of the definition of "qualified trust," which requires all interests of beneficiaries to be identical to each other (CCRA document no. 2001-0072645, August 24, 2001). In concluding that the units did not satisfy this test, the CCRA focused on three things: first, that such a redemption mechanism did not appear to be consistent with the scheme of section 259; second, that such a mechanism did not appear to avoid prejudicing any non-redeeming beneficiary; and third, that the definition of "proceeds of disposition" in the Act did not include a provision for a reduction of what would otherwise be the redeeming unitholder's share of the fair market value of the assets held by the trust by the income (assumed to be a capital gain) generated by the sale of an asset to generate funds to pay the redemption.

In the small business investment limited partnership context, the conclusion appears to be so obvious that one has to wonder why the technical interpretation question was ever requested. In the trust context, it appears that the writer conceded that the units were not identical in all respects, but then attempted to justify the difference on some basis of fairness. Given that the CCRA did not agree with the fairness argument put forward by the writer, it was able to dismiss the issue on this basis without any real analysis as to whether in fact such units were identical in all respects. The argument may, however, have sensitized the CCRA to the potential for abuse in this area.

than an investor who participates in the investment. Given the potential for such differing treatment, it was the CCRA's view that the units could not, "at all times," be considered identical in all respects.

There are a number of difficulties with the CCRA's argument. First, the definition of "qualified limited partnership" in regulation 5000(7) is retrospective, not prospective: the conditions specified therein must be met "at all times after the [partnership] was formed and before the particular time." On a plain reading of the definition, it is apparent that compliance with the identical-unit requirement (and all the other conditions set out regulation 5000(7)) is measured retrospectively back to the formation of the partnership; the test is not prospective. Therefore, in the case of a partnership with a single class of issued and outstanding units which provides that the entitlement of a limited partner to share in the income, gain, or loss of the partnership is pro rata with other limited partners except and until the happening of a certain event (which condition applies equally to all units), the units are identical in all respects unless and until the event occurs and a limited partner's entitlement ceases to be pro rata with all of the other limited partners. To interpret the definition to require prospective conformity with the requirement, as the CCRA appears to have been doing, is to ignore the plain meaning of the regulation and is contrary to well-established principles of statutory interpretation.[42] The fact that particular circumstances in the future may result in some but not other limited partners' rights to distributions being suspended is not relevant to the analysis. Therefore, even if the happening of an event such as the default or exclusion of an investor could result in a differentiation not permitted by the identical unit requirement, before the event occurs, this test should still be met.

Legal opinions on the retrospective nature of regulation 5000(7) have been submitted to the CCRA with regard to the exception or exclusion of a limited partner from certain investments. At least in this context, the Department of Justice has agreed that the mere existence of such a provision does not offend the regulation 5000(7)(d) requirement that the units of the partnership be identical in all respects. In light of this agreement, the CCRA has reconsidered its view and conceded that the mere existence of such a provision in a limited partnership agreement will not jeopardize the status of a fund as a qualified limited partnership. The CCRA has also amended one of its previously issued rulings to specifically affirm this result.[43] In so doing, it withdrew what could be described as a "blanket ruling" confirming that the terms of the draft agreement governing the partnership in question as a whole complied with the identical unit requirement and replaced it with the following ruling:

> Provided the Partnership qualifies as a "qualified limited partnership" in all respects within the meaning of subsection 5000(7) of the Regulations, the existence of the provisions of . . . the Draft Agreement [i.e., the exclusion provision] . . . will not, in

42 For example, see *Antosko et al. v. The Queen*, 94 DTC 6314 (SCC).

43 See CCRA document no. 2000-0006283, July 18, 2000.

> and of itself, cause the units of the Partnership not to be identical in all respects. However, if the terms of . . . the Draft Agreement . . . are exercised in respect of a Limited Partner, the Partnership will cease to qualify as a "qualified limited partnership" from the date of exercise of those terms as the units of the Partnership will thereafter cease to be identical in all respects, as required in the definition of "qualified limited partnership" under paragraph 5000(7)(d) of the Regulations.[44]

To deal with other "if and when" provisions such as default, the CCRA also provided the following comment:

> In our view, the units of a "qualified limited partnership" as defined in subsection 5000(7) of the Regulations, may be considered to be "identical in all respects" on the basis that the interests of the limited partners were described by reference to units of the partnership that were identical in all respect at the time of issuance. However, a limited partnership will cease to be a "qualified limited partnership" at the time any term or clause in a partnership agreement is exercised which would cause the interests of the limited partners which were described by reference to units of the partnership that were identical in all respects to no longer be identical.[45]

Given that both the Department of Justice and the CCRA have accepted the retrospective nature of the qualified limited partnership definition, and given the existence of the comment to the ruling quoted above, it appears that the "until exercised" concept can safely be expanded to various other provisions that, on the happening of a specified event, have the *potential* of differentiating units (for example, provisions dealing with default). Accordingly, the mere *existence* of provisions of this type should not jeopardize the status of a fund as a qualified limited partnership.

Although the CCRA's acceptance of the retrospective nature of the qualified limited partnership definition is an answer to the many "if and when" types of provisions, it does not deal with all the types of potentially problematic provisions that were raised by the CCRA with respect to the identical unit requirement (for example, limited voting rights). These other types of provisions raise the second and perhaps even more compelling argument against the CCRA's position on what constitutes an identical unit—namely, the fact that the provisions with which the CCRA has raised concern apply equally to each unit. Accordingly, such provisions form part of a bundle of rights and obligations that are identical in all respects vis-à-vis each unit. This is in sharp contrast to the underlying purpose of the identical unit requirement—namely, to ensure that unitholders are not treated differently (for example, by streaming income on the basis of tax status). The purpose of these provisions is not to differentiate among investors but to deal with bona fide commercial issues that arise when certain events occur; they are not inserted in an attempt to manipulate an outcome or to treat investors differently.

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44 CCRA document no. 2002-013816D, dated 2002.

45 Ibid.

The fact that certain economic results follow the triggering of an event contemplated by the bundle of rights that comprises a property does not mean that the property is different from another property with the same bundle of rights but in respect of which such an external event has not been triggered. This is consistent with the CCRA's view of what constitutes identical property for the purposes of subsection 47(1). As set out in *Interpretation Bulletin* IT-387R2, the test for determining whether properties are identical for subsection 47(1) purposes is as follows:

> "Identical properties" . . . are properties which are the same in all material respects, so that a prospective buyer would not have a preference for one as opposed to the other. To determine whether properties are identical, it is necessary to compare the inherent qualities or elements which gave each property its identity. Such a determination is a question of fact which must be decided on the basis of the relevant details in each situation. . . .
>
> Two properties which are otherwise identical do not cease to be so merely because one is subject to a charge or other external condition which may affect its price and the other is not, provided the external condition does not change any of the constituent elements of the particular property (e.g. provincial retail sales tax, commission fees).[46]

In the context under consideration, a prospective buyer would not have a preference for one unit over another, given that the attributes of each are identical in all respects. This supports the argument that the provisions in question are not intended to favour one investor over another or to "stream" tax-preferred items in favour of certain investors.

This position is supported by commercial law, which recognizes the concept of a limited partnership interest as a proprietary or economic interest in the partnership assets. Therefore, the identical-unit requirement should not be expanded to deal with every aspect of the relationship among the partners of a partnership.[47] Rather, it is only the proprietary or economic rights that must be described by reference to units, and it is only these rights that must be identical in all respects. Interpreting regulation 5000(7)(d) in this manner is not only consistent with the tax policy underlying the provision (to prevent income streaming), but is also commercially reasonable and accords with the purpose for which the qualified limited partnership rules were enacted—namely, to provide industry with a more flexible means of making venture capital investments.

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46 *Interpretation Bulletin* IT-387R2, "Meaning of 'Identical Properties'" (consolidated), paragraphs 1 and 3.

47 See, for example, section 18 of the LPA. Section 18 distinguishes between an assignee of a limited partner's interest and a "substituted limited partner." Whereas the former "is entitled only to receive the share of the profits or other compensation by way of income or the return of the contribution to which the assignor would otherwise be entitled," the latter, subject to specific exceptions, "has all the rights and powers and is subject to all the restrictions and liabilities of the limited partner's assignor." In other words, section 18 distinguishes between the concept of an interest of a limited partner (that is, the proprietary or economic rights) and the broader rights and obligations related to the status of a person as a limited partner.

Fortunately, at least in the context of matters such as the variation in voting rights, the right to participate in investment advisory committees, and co-investment rights, the Department of Finance appears to have accepted the policy basis underlying the foregoing argument. As a result, in the 2003 budget proposals it has indicated that it will relax the requirement that qualified limited partnership units be identical to accommodate differences in units that do not affect the share or nature of the partnership's income or loss allocated among limited partners. The types of rights listed above will no longer give rise to issues with respect to the identical nature of the qualified limited partnership units to which they relate.

Although the 2003 budget proposals offer a welcome relaxation of the identical-unit requirement, in my view they do not go far enough in alleviating the practical difficulties of structuring qualified limited partnerships. As the Canadian Venture Capital Association (CVCA) has argued, the qualified limited partnership definition should be modified in order to permit limited partnership units to be treated differently in a broader range of circumstances, including the case where a limited partner is in default of its obligations or has been excluded from a particular investment. Given the commercial necessity of provisions of this type and the complete absence of any streaming motivation behind their use, it is suggested that amendments of this nature should no more be viewed as compromising the policy underlying the identical unit requirement than those introduced by the 2003 budget proposals. Unfortunately, at the present time the Department of Finance does not share this view. Although it may be persuaded to expand the relief offered in respect of the identical unit issue before the enacting legislation is finalized, there is no current indication that it will do so. Accordingly, funds that are structured as qualified limited partnerships should exercise extreme caution in dealing with provisions that can differentiate rights of investors in situations other than those specifically identified in the 2003 budget proposals.

Sole Undertaking of the Fund and Nature of Investments

Regulation 5000(7)(f) requires that the only undertaking of the fund be the "investing of its funds." Accordingly, a qualified limited partnership cannot carry on a business (other than an investment business)—it can merely invest its funds in property. This requirement is similar to that placed on unit trusts, mortgage investment corporations, mutual fund trusts, and mutual fund corporations.

Given the narrower scope of assets in which a qualified limited partnership can invest, fewer issues have arisen in respect of the investment limitation in the qualified limited partnership context than in the context of mutual fund trusts or corporations. For example, in this context, the issues that arose with respect to mutual funds investing in limited partnerships (now dealt with in section 253.1)[48] are not

48 Section 253.1 was added by the 2001 technical bill, and is generally effective for 1993 and subsequent taxation years. Section 253.1 ensures that the mere acquiring and holding of a limited partnership interest by a trust or corporation will not jeopardize the classification of the trust

relevant, because a qualified limited partnership cannot invest in, inter alia, limited partnership interests.

The question that does arise in respect of the requirement that the only undertaking of the partnership be the "investing of its funds" is whether the fund must confine itself to acquiring property only on capital account. Although it is arguable that the terms "invest" and "investment" suggest that only capital transactions are permitted, the CCRA appears to interpret the phrase "investing of its funds" more generously. In its view, the mere fact that some transactions are on income rather than capital account does not necessarily result in a breach of the "investing" requirement. For example, in the mutual fund context, the CCRA has said that buying, selling, or otherwise taking a position in futures contracts, forward contracts, and options on futures contracts (based on, among other things, a commodity, a commodity index, a foreign currency, a stock index or a bond index) will generally be considered the "investing of funds" notwithstanding that such activities are on income account;[49] the lending or borrowing of qualified securities under a securities lending arrangement (as defined in subsection 260(1)) will also generally fall within the meaning of that phrase.[50] In the context of a qualified limited partnership, the CCRA has twice ruled that a fund can earn passive transaction income such as commitment fees, standby fees, completion fees, and guarantee fees without jeopardizing its status under regulation 5000(7).[51] In one of these rulings, the CCRA also confirmed that the purchase of a surety bond as insurance for potential losses of the partnership will not cause the partnership to be denied such status.[52]

Given that the CCRA has accepted that the "investing of funds" can generate income rather than capital receipts, it is possible that the activities of a fund can take on the character of an investment business without breaching regulation 5000(7)(f). Characterizing a fund's gains as generating business income has negative implications not only for Canadian-resident investors, but also for non-residents contemplating an investment in such a fund. Venture capital funds normally take the position that their investment transactions are on capital rather than income account. Although this conclusion is not entirely free from doubt, it appears to be an industry practice that is accepted by the CCRA. Notwithstanding such tacit acceptance, however, the issue should be considered in both the domestic and the foreign context.

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or corporation under the provisions that require it to limit its undertakings to investing of its funds. This provision responds to the Federal Court of Appeal decision in *The Queen v. Robinson et al.*, 98 DTC 6065, which held that limited partners carry on the business of a partnership.

49 For example, see *Income Tax Technical News* no. 6, January 5, 1996. See also CCRA document no. 9728675, July 2, 1998 and CCRA document no. 9711923, October 2, 1997.

50 CCRA document no. 9606285, April 18, 1996.

51 CCRA document no. 9911433, May 25, 2000 and CCRA document no. 9711923, October 3, 1997.

52 CCRA document no. 9711923, October 3, 1997.

Permitted Investments

As noted above, not only must the sole undertaking by the fund be the "investing of its funds," such funds can be invested only in specified types of properties:

1. shares of the capital stock of corporations (other than certain exploration and development shares or certain share purchase tax credits shares);
2. rights, or warrants that grant the owner thereof rights, to acquire shares of the capital stock of corporations;
3. put or call options in respect of shares of the capital stock of corporations;
4. debt obligations of corporations;
5. bonds, debentures, notes, mortgages, or similar indebtedness of certain government bodies;
6. bonds, debentures, notes, or similar obligations of a corporation the shares of which are listed on a prescribed stock exchange in Canada (other than indebtedness of an employer corporation or corporation that does not deal at arm's length with such a corporation);
7. money (other than money the fair market value of which exceeds its stated value as legal tender in the country of issuance or money that is held for its numismatic value) and certain deposits;
8. guaranteed investment certificates issued by a trust company incorporated under the laws of Canada or of a province; and
9. certain investment contracts.

Absent from the foregoing list are interests in limited partnerships and trusts. Notwithstanding the relatively broad nature of the investments which a qualified limited partnership can make, those types of properties cannot be acquired by a venture fund that is structured as a qualified limited partnership.

The restriction on qualified limited partnership investments raises two issues. First, the type of assets in which the fund can invest must be carefully considered in order to ensure that the fund does not breach the regulation 5000(7)(f) requirements. As noted above, the definition of "qualified limited partnership" requires the fund to comply with the listed requirements "at all times after it was formed and before the particular time." An inadvertent acquisition of a prohibited asset is fatal to a fund's qualified limited partnership status and cannot be remedied after the fact.

Second, as discussed in more detail below, where parallel investments are made in reliance on section 115.2, careful consideration must be given to the difference between the regulation 5000(7)(f) assets and the types of assets that constitute "qualified assets" for section 115.2 purposes. Although there is significant overlap between the two provisions, the latter category is generally broader in scope (for example, investments in both limited partnerships and trusts are permitted).

Given the absence of any compelling policy reasons for prohibiting a qualified limited partnership from investing in limited partnership interests or trust units, the investment requirements of regulation 5000(7)(f) are unduly restrictive and should be modified. As discussed above, this would also better align the qualified limited partnership vehicle with the investment vehicles contemplated in section 115.2, which are often used by non-resident investors in this context. Although industry has lobbied the Department of Finance to extend the permitted scope of investments under regulation 5000(7)(f), it has met with limited success. In the recent 2003 budget proposals, Finance has indicated that for 2003 and subsequent taxation years it will relax the investment limitations on a qualified limited partnership to allow it to invest, as a limited partner, in units of other qualified limited partnerships. (However, in order to prevent a qualified limited partnership from effectively increasing its foreign property content by tiering its qualified limited partnership investments, for the purpose of applying the foreign property limit to the investing qualified limited partnership, the units of the other qualified limited partnerships will be treated as foreign property of the investing qualified limited partnership in the same proportion as the foreign property held by the other qualified limited partnership.) Finance has rejected the broadening of the permissible scope of investments beyond this narrow category of partnership vehicles.

From telephone conversations with Finance officials, it appears that the rationale for limiting the types of investments that a qualified limited partnership can make relates to the initial purpose for which the qualified limited partnership rules were enacted—namely, to provide industry with a more flexible form of vehicle to make venture capital investments. Apparently, Finance did not view broadening the scope of permitted investments to include, for example, trust units, to be in keeping with this objective. The example Finance gave was investment in a mutual fund trust (which the CVCA expressly lobbied Finance to permit). From Finance's point of view, the difficulty with such an investment was that it was not, per se, necessarily supportive of the interests of the venture capital industry. Further, given the broad scope of the investments that a mutual fund trust can make, Finance expressed the concern that indirectly permitting such an investment could allow for a greater scope of investments than was intended by the qualified limited partnership rules.

Although Finance's desire to maintain the focus of the qualified limited partnership rules on venture capital investments is understandable, it is unfortunate that it chose to relax the investment rules in such a limited fashion. It is true that an investment in a mutual fund trust, per se, may not advance the interests of the venture capital industry. But as the name makes clear, the mandate of a venture capital fund is to seek out venture capital investments. Accordingly, it is assumed that such a fund would invest only in a mutual fund trust that specialized in such types of investments. Furthermore, not all venture capital investments are themselves structured on a share equity basis. (For example, such investments may come in the form of trust units.) I am aware of at least one situation in which an investment of this type emerged and made it necessary to form a parallel investment vehicle to accommodate it. Although it is possible to deal with such non-share investments in this fashion, it is both costly and time-consuming. For this reason, and for the purposes of coordinating the qualified limited partnership rules with the safe harbour provisions of section 115.2, it is hoped that Finance will revisit these rules before the enacting legislation is finalized. Telephone conversations with Finance officials suggest that they are open to submissions in this area, provided that the policy objectives of supporting capital venture investments are not compromised in the process.

Finally, if pension plan investors are targeted, then consideration should be given to the "prohibited investment" rules in regulation 8514. Regulation 8502(h) requires that a pension plan's investments not include a "prohibited investment" under regulation 8514(1) or any investment not permitted under the pension legislation that governs the plan. The "prohibited investment" rules are designed to prevent a registered pension plan from investing in securities of an employer or of certain other persons connected with the employer and are similar to the restrictions on related-party investments in the pension benefits legislation of most jurisdictions. Exceptions are provided for, among other things, publicly traded shares and debt of publicly traded companies. When drafting a qualified limited partnership agreement, it is prudent to take these rules into account in determining the scope of the partnership's permitted asset base.

The Subsection 97(2) Election

In order for a fund to be a qualified limited partnership, it must not have acquired property on a rollover basis under subsection 97(2). Although this requirement is normally not problematic, it should be kept in mind when funding the partnership. For example, if investments are purchased on behalf of the fund, care must be taken in ensuring that such "warehoused" investments can be transferred to the fund at cost without the use of a subsection 97(2) election. The documents relating to such assets should clearly indicate the capacity in which they were purchased—agent, trustee, or fiduciary. Otherwise, problems might arise if the assets have been dedicated to the fund but have appreciated in value since the date of acquisition.

Restrictions on Borrowing

By virtue of regulation 5000(7)(h), a qualified limited partnership cannot borrow money except for the purposes of earning income from its investments. Further, the amount of any such borrowing cannot exceed 20 percent of the partnership's capital at any time. Again, while this is not usually a problem in structuring most funds, it is a factor that has to be considered, particularly at the outset when the partnership is not fully capitalized.

Foreign Property Content

By virtue of regulation 5000(7)(i), a qualified limited partnership must comply with the 30 percent foreign property limit. Unlike certain investors to which the foreign property limits apply (registered retirement savings plans, deferred profit-sharing plans, registered retirement income funds, registered investments, and certain other persons exempt from tax under part I), qualified limited partnerships must meet these limits at all times, not merely at the end of the month. Foreign property levels must be strictly monitored to ensure that the 30 percent threshold is not exceeded, particularly when an asset is acquired or sold.

To alleviate the monitoring concerns raised by the current foreign property limitations, the manner in which the foreign property limit is applied to qualified limited partnerships will be changed to more closely reflect the manner in which the limit is applied to mutual fund trusts. Specifically, under the 2003 budget proposals, a partnership will qualify as a qualified limited partnership throughout a particular calendar year if the partnership satisfied the foreign property limit throughout the previous calendar year. As noted above, this test is similar to the "relevant period" test that applies in determining whether units of mutual fund trusts are foreign property. Like the other 2003 budget proposals, this measure will apply for 2003 and subsequent taxation years.

PARALLEL INVESTMENTS

There are a number of reasons for using a parallel investment mechanism in conjunction with the main fund. From a domestic perspective, the two main reasons are to accommodate investments that a qualified limited partnership could not itself make and to ensure that the status of the fund sponsor does not taint the status of the partnership or the nature of its investments. From a foreign perspective, such structures have been used to avoid certain compliance issues and to provide non-residents with an added layer of protection against the possible imposition of Canadian tax.

Domestic Issues

Accommodating Investments Subject to the Prohibition in Regulation 5000(7)(f)

As discussed above, regulation 5000(7)(f) restricts the types of investments that a qualified partnership can make. For example, if a limited partnership or trust investment is identified for the portfolio, the main fund cannot acquire that investment directly without jeopardizing its status as a qualified limited partnership. A separate but parallel partnership vehicle must be used to make the investment.

Obviously, such a parallel investment entity will not be a qualified limited partnership and therefore will not be subject to the restrictions in regulation 5000(7)(f). Although the units of such an entity will constitute foreign property, only the particular investment acquired by a tax-exempt through the parallel fund is subject to foreign property classification. In contrast, if the main fund acquired a non-permitted asset, it would lose its qualified limited partnership status and would taint the tax-exempt's entire interest in the main fund.

In a parallel structure, the qualified limited partnership and any other parallel partnership created to facilitate investment by the investors invest proportionately on the basis of their respective capital commitments in all the investments on effectively the same terms and conditions (except as may be dictated by differences in legal structure). The terms and conditions of such a parallel partnership will have to largely mirror the terms and conditions of the qualified limited partnership; this requires the members of the parallel partnership to be largely the same as the members of the qualified limited partnership.[53]

Notwithstanding the virtually identical terms of the qualified limited partnership and the parallel partnership, some adjustments will have to be made to the terms of the parallel partnership in order to bridge the economics between the two.[54] Examples of four such adjustments are set out in a ruling dated October 3, 2001,[55] which dealt with the creation of a parallel investment vehicle.

First, although profits and losses under the parallel partnership were allocated in the same manner as under the qualified limited partnership, the general partner of the parallel partnership was subject to an additional clawback over and above that applicable to the qualified limited partnership. Under the additional clawback, the general partner was required to contribute funds to the parallel partnership if

1. the general partner of the parallel partnership received a profit allocation from the parallel partnership and, as general partner, from the qualified limited partnership; and
2. the limited partners of the parallel partnership did not receive distributions from the parallel partnership and, as limited partners from the qualified limited partnership, in an aggregate amount equal to or greater than the amount of their aggregate capital contributions to and preferred return from the two partnerships (referred to as "the minimum partnership distribution amount").

The amount of the contribution, however, was not to exceed the combined net profit (after payment of taxes) thereon received by the general partner, as general partner, from the parallel and qualified limited partnerships. Any amount received

53 There is one published example of a parallel partnership structure in respect of which a ruling was obtained: CCRA document no. 2001-0087263, October 3, 2001. In that ruling, all the members of the parallel partnership were identical to the members of the qualified limited partnership. However, in a supplementary ruling of the same date, CCRA document no. 2001-0051823, an additional member was inserted into the parallel partnership which was affiliated to the fund sponsor. As discussed below, this was done to support the common law position that the parallel partnership was a distinct and separate entity from the qualified limited partnership.

54 Alternatively, such adjustments could be made by means of a separate "bridging" agreement. However, given the concerns (discussed below) relating to the separate partnership issues raised by such a mechanism and the lack of any published guidelines or rulings on point, the safer route is to bridge the two partnerships by adjustments in the parallel partnership agreement. Although it is understood that a comfort letter has been provided on a bridging structure, the preferable route would be to use an adjustment mechanism such as that used in the parallel partnership ruling, CCRA document no. 2001- 0087263, October 3, 2001.

55 Ibid.

pursuant to the additional clawback was to be distributed to the partners of the parallel partnership (including the general partner) in proportion to their respective commitments.

Second, in the event that the limited partners of the parallel partnership received aggregate distributions in excess of the minimum partnership distribution amount and the general partner of the parallel and qualified limited partnerships received distributions over the life of the two funds in excess of its carried interest, the general partner of the parallel partnership was required to make a capital contribution to the parallel partnership equal to 100 percent of such excess. Again, that amount was to be distributed to the partners of the parallel partnership (including the general partner) in proportion to their respective commitments.

Third, although the general partner of the parallel partnership was to receive an annual management fee from the partnership based on the commitments and/or the cost basis of investments held by the partnership using the same stepped-down formula that was used for the qualified limited partnership, the fee was subject to certain reductions based on management fees paid by the qualified limited partnership; the deadlines for payment were also adjusted to take into account the date on which the parallel partnership was formed.

Fourth, the parallel partnership had different business objectives because it was not subject to the restrictions and limitations set out in regulation 5000(7) and, in particular, the investment limitations in the definition of a qualified limited partnership in regulation 5000(7)(f). Accordingly, the nature of its permitted investments differed from the nature of the permitted investments of the qualified limited partnership.

Owing to the notional segregation of the original commitments between the qualified limited partnership and the new parallel partnership entity, the commitments in respect of the qualified limited partnership were reduced and reflected in the new capital commitments of the parallel partnership. Conceptually, the qualified limited partnership and parallel partnership functioned on a bridged basis to enable the fund to make investments that the qualified limited partnership could not make without jeopardizing its status under regulation 5000(7). In essence, the differences between the qualified limited partnership and the parallel partnership served to link the two partnerships to ensure this economic result. Although this served the goal of preserving the economics of the fund as a whole, it raised the question whether the parallel partnership would be recognized as a partnership that was separate and distinct from the qualified limited partnership. For tax purposes, this was of crucial importance: if the qualified limited partnership and the parallel partnership were viewed as a single partnership, the qualified limited partnership would be considered to have acquired investments not listed in regulation 5000(7)(f). This would not only cause the general partner to be in breach of its obligations under the qualified limited partnership agreement, but it would also compromise the tax position of the tax-exempt limited partners because an interest in the qualified limited partnership would become foreign property, thus negating the purpose for which the qualified limited partnership was established.

From a tax perspective, the October 3, 2001 ruling confirms that a structure such as that outlined above would not be challenged by the CCRA. Provided that the parallel partnership was organized on the basis set out above and was considered separate and distinct from the qualified limited partnership under common law, the CCRA ruled that the activities of the parallel partnership would not be considered to be activities of the qualified limited partnership for the purposes of regulation 5000(7)(f). Accordingly, the activities of the parallel partnership would not affect the activities of the qualified limited partnership. In addition, the CCRA suggested that subsection 245(2) would not apply to the arrangement. Although that statement was made in a comment, not a ruling, considerable comfort can be taken from this, given that the CCRA's expressed reason for not being able to provide a ruling was that neither a "tax benefit" nor an "avoidance transaction" (both of which are prerequisites to the application of subsection 245(2)) could be identified.

The ruling is premised on the assumption that the two partnerships were separate partnerships under common law. As discussed below, although there is virtually no Canadian jurisprudence on point, if structured properly, the separate existence of the two partnerships should be respected.

Separate Partnerships at Common Law

Virtually no Canadian jurisprudence deals with the circumstances in which two partnerships will be considered separate and distinct from one another. The only case in which such a finding appears to have been made is *Medicine Hat Wheat Co. v. Norris Commission Co.*,[56] in which the court was asked to determine the proper parties to a disputed contract—the defendants and Medicine Hat Wheat Co. or another purported partnership, made up of largely the same members. In making this determination, the court considered whether the two partnerships were one and the same or separate and distinct entities. It noted that the two partnerships conducted business out of the same office and employed the same bookkeeper and stenographer; however, although the partnerships had common members, they were not identical, and the firm names and stated business purposes were different. On the basis of these facts, the court, citing the *Cyclopedia of Law and Procedure*,[57] concluded that the two partnerships were separate and distinct from one another:

> It seems to me that as the law now stands, each separate partnership must be recognized as a separate entity. It is laid down in 30 Cyc. 555: "Where different firms have common members each partnership is dealt with by the courts as having a joint fund of its own and its own set of creditors, who are as clearly entitled to that fund in preference to the creditors of any partnerships connected with ties of a common partner, as they are entitled in preference to the individual creditor of its members."[58]

56 (1917), 37 DLR 188 (Alta. SC).

57 William Mack and Howard P. Nash, eds., *Cyclopedia of Law and Procedure* (New York: American Law Book, 1901-1912).

58 Supra note 56, at 191.

With the exception of that statement, the court offered no other guidelines or reasons for determining why the two partnerships should be treated as separate and distinct from one another.

In *Medicine Hat*, the two firms had members in common, but their membership was not identical. Although there is no direct Canadian authority on point, in the United States there is some suggestion that if two partnerships have identical members, such partnerships will not be respected as separate and distinct. For example, in *Fidelity Phoenix Fire Insurance Co. v. Howard*,[59] the court was asked to deal with a clause that excepted from liability coverage thefts by the insured's employees. The insured, a partnership, argued that there were two partnerships with separate businesses even if the partners were the same, and that the employee involved was employed by the other partnership. In finding that there was only one partnership, the court stated the following:

> A partnership of identical partners under one partnership name is the same partnership when conducting some other portion of its business under another name,—whatever the name, there is still the same partnership. . . . [Ownership] and ultimate control are still in the partners who compose the firm.[60]

Similarly, in *Com. Feed Stores v. Dir. of Div. of Employ.*,[61] the court was asked to consider whether two partnerships with the same members should be treated as the same employer for unemployment compensation purposes. In coming to the conclusion that they should, the court stated: "Where the aggregate theory prevails, such judicial authority as there is indicates that two or more separate partnerships with identical partners will not be recognized."[62]

English jurisprudence, in contrast, appears to accept the notion that two or more partnerships with identical members can be recognized as separate and distinct from one another. For example, the London VAT tribunal stated the following in *Bertram & Co. v. The Commissioners*:

> Mr. Fearnehough went a little further than saying that there was only one partnership here, he went so far as to submit that you cannot have two different partnerships between the same two people. He was not able to cite any authority in support of that proposition and we are unable to accept it. The first question in this case, as we understand it, is whether or not there was one partnership or two partnerships here. In our view it is perfectly possible for the same two, or the same three or more, people to join together in separate partnerships for different purposes.[63]

59 182 Miss. 546 (SC 1938).

60 Ibid., at 551.

61 462 N.E. 2d 105 (Mass. SC 1984).

62 Ibid., at 107.

63 [1973] VATTR 43, at 45 (overturned on another point).

The cases noted above show that, at common law, it is unclear whether two or more separate partnerships with identical members can exist. Therefore, in structuring a parallel investment partnership, it is prudent to ensure that there is at least one different member in the partnership. (This is the approach taken in the parallel partnership ruling discussed above.)[64] If that precaution is taken, the fact that the partnerships have members in common but not identical members, brings the situation within the fact pattern considered in *Medicine Hat*, the only relevant Canadian authority on point.

In the absence of definitive jurisprudence, the following general principles would have to be argued to support a conclusion of separate existence in the context of a parallel investment partnership structure:

1. The two partnerships carry on separate businesses pursuant to two separate and distinct partnership agreements.
2. Each partnership is registered separately under the LPA and carries on a separate business under a separate and distinct name.
3. The dissolution of one partnership will not result in the dissolution of the other.
4. Substantially different economic ramifications will result if an investment in one partnership or the other is made.

Carrying On Separate Businesses Pursuant to Two Separate Partnership Agreements

Whether a partnership exists is determined by provincial law. This was recently confirmed by the Supreme Court of Canada in *Continental Bank Leasing Corporation v. The Queen et al.*[65] and is consistent with the CCRA's stated position, including that set out in paragraph 2 of *Interpretation Bulletin* IT-90,[66] dealing with the question of what constitutes a partnership.

In *Continental Bank*, Bastarache J said, "The existence of a partnership is dependent on the facts and circumstances of each particular case. It is also determined by what the parties actually intended."[67] Similarly, R.C. I'Anson Banks, in *Lindley & Banks on Partnerships*, the leading Commonwealth authority on the law of partnerships, said, "In determining the existence of a partnership . . . regard must be paid to the true contract and intention of the parties as appearing from the whole facts of the case."[68] The partial definition of "limited partnership" in section 2(1) of the LPA states that a "limited partnership may, subject to this Act, be formed to carry on any business that a partnership without limited partners may carry on." Section 46 of

64 See the supplementary ruling, CCRA document no. 2001-0051823, October 3, 2001.

65 98 DTC 6505 (SCC).

66 *Interpretation Bulletin* IT-90, "What Is a Partnership?" February 9, 1973.

67 Supra note 65, at paragraph 143.

68 R.C. I'Anson Banks, *Lindley & Banks on Partnership*, 17th ed. (London: Sweet & Maxwell, 1995), 73.

the Partnerships Act[69] (PA) implicitly provides (and has been interpreted by the CCRA to provide)[70] that a limited partnership formed under the LPA is subject to the provisions of the PA, including section 2, which defines the term "partnership" as "the relation that subsists between persons carrying on business in common with a view to profit."

According to the definition in section 2 of the PA, the following three elements must be present in a partnership:

1. there must be a business;
2. that business must be carried on by two or more persons in common; and
3. that business must be carried on with a "view to profit."

A qualified limited partnership and any partnership formed in parallel should be considered separate and distinct partnerships because they are intended by the parties to the respective partnership agreements to be separate and distinct partnerships and because the respective partnership agreements establish distinct terms and conditions, including, most importantly, distinct businesses for each partnership.

"Business" is defined in section 1 of the PA to include "every trade, occupation and profession." According to *Lindley & Banks on Partnerships*, "business" can include any "activity or venture of a commercial nature including a 'one off' trading venture."[71] Because there are provisions in the contract that establishes a qualified limited partnership which stipulate that the business is restricted to investments listed in regulation 5000(7)(f), but no similar provisions in the contract that establishes a parallel partnership, the business of the qualified limited partnership and the parallel partnership must, by virtue of the terms of these agreements, necessarily be distinct. Although one might argue about the degree of differentiation necessary to distinguish one business from another, given the significance of the regulation 5000(7)(f) restriction, the differing scope of business activity should be viewed as material in the circumstances. As a result, the partnerships themselves should be considered separate and distinct partnerships.

Registered Under Separate Names Under the LPA

To obtain limited liability protection, a partnership must file a declaration under the LPA; pursuant to section 3(1) of the LPA, a limited partnership is not formed until a declaration is filed with the registrar. Each such declaration expires, pursuant to the provisions of section 3(3) of the LPA, five years after the date of its registration. Consequently, each separate registration identifies to third parties that such a partnership constitutes a separate and distinct limited partnership. The fact that registration is made under a different name for each partnership also indicates to

69 RSO 1990, c. P.5, as amended.

70 See CCRA document no. 2000-000122, June 13, 2000.

71 Supra note 68, at 8.

third parties that the two partnerships are separate and distinct entities. Although the filing of a declaration in respect of a qualified limited partnership and a parallel partnership is probably not sufficient, in and of itself, to constitute such partnerships as separate and distinct partnerships under Ontario law, where (as in most cases) there are material differences between the two partnerships, the filing of two separate declarations should at the very least be viewed as confirming separate existences. The manner in which the partnerships represent themselves in dealings with third parties is indicative of the intentions of the relevant parties—a principle that is one of the cornerstones of a partnership relationship.

The fact that the partnerships are separately registered and treated as separate partnerships under their respective agreements is also important to the limited liability of the respective partners. For example, if a limited partner actively participates in the business activities of one of the partnerships and loses its limited liability status in respect thereof, the partner would still have limited liability protection in respect of the other partnership (provided, of course, that it did not actively engage in the business activities of the other partnership). If the separate registration of the partnerships was ignored and the two entities were effectively treated as one partnership, the partner's limited liability protection would be lost in respect of both partnerships. Given the significance of such a result, a court would not lightly disregard the separate registration (and the resulting liability protection) of the two partnerships.

Dissolution

The position that the partnerships are separate and distinct means that the dissolution of one of the partnerships does not necessarily entail the dissolution of the other and that the different creditors of each partnership have priority access to the assets of their respective debtor partnerships.[72] As discussed above, such creditor access was the focus of the decision in *Medicine Hat* and supports the argument that each partnership has a separate fund of assets and set of creditors who are entitled to that fund in preference to the creditors of any partnership with a common partner or partners.

Differing Economic Results

An investment in a qualified limited partnership is not considered foreign property for the purposes of the Act, but an investment in the parallel partnership is. The distinction between the two partnerships is not merely theoretical, but has a material economic impact on its partners. Although this factor is tied to the intention test, it should be given some weight in its own right, owing to the serious implications for certain investors.

72 See sections 39 and 44 of the PA and section 142 of the Bankruptcy and Insolvency Act, RSC 1985, c. B-3, as amended.

The separate existence of the partnerships will also be evident in the manner in which the parties report their relationship for tax purposes. In the present context, this means filing tax returns on the basis that there are two separate partnerships, one of which, in the case of a tax-exempt, constitutes foreign property for tax purposes. Although it is not determinative of the substance of the relationship between the relevant parties, this is one factor that indicates their intention to form two separate partnerships.[73]

A parallel limited partnership with at least one different member (and the type of differentiating characteristics discussed above) should be respected as a separate partnership from the qualified limited partnership. A partnership is a relationship that results from a contract, and the existence of that relationship depends on the true intentions of the contracting parties. Assuming that the three essential elements are met (namely, the presence of a business, carried on in common, with a view to profit), the parties should be entitled to contractually define their relationship as they see fit. By entering into two separate partnership agreements with different business purposes, registering such agreements separately, and treating the partnerships as separate for tax purposes, the parties can substantiate that their true intention was to create two separate partnerships. This, when combined with the CCRA's express ruling that it will not challenge such a structure from a tax perspective, should give potential participants a fair degree of certainty that their intentions will be respected. Such a structure appears to be a relatively safe method of accommodating investments that the qualified limited partnership could not itself make.

The Status of the Partnership and the Nature of the Partnership Investments

The fund sponsor is often a bank, a trust company, an insurance company, an investment dealer, or a corporation controlled by them, and therefore is a "financial institution" for the purposes of sections 142.2 to 142.6 of the Act. Sections 142.2 to 142.6 contain a comprehensive set of mark-to-market rules which determine the tax treatment of shares and debt held by financial institutions. The legislation standardizes the tax treatment of securities held by financial institutions by requiring the institutions to mark to market some types of securities on an annual basis

73 The relevance of the manner in which parties report their relationship for tax purposes is evident from the following excerpt of Rip J in *Backman v. The Queen*, 97 DTC 1468, at 1474 (TCC) (aff'd. 2001 DTC 5149 (SCC)): "Stephen David Marcus, a tax attorney in Dallas, Texas testified for the Crown as an expert in United States tax law, specifically, reporting requirements under the Internal Revenue Code of the United States ('Code'). Whether the transactions under review are taxable or not under United States tax law is not my concern; U.S. tax law is irrelevant to my determination of their tax treatment under the *Income Tax Act* of Canada. *Nevertheless I allowed Mr. Marcus' evidence because I thought his evidence may shed some light on what the parties believed took place between them and when. In other words, could the documentation filed with the U.S. tax authorities assist me in discovering how the parties themselves saw the purported transactions?*" [Emphasis added.]

(and thereby to realize annually any accrued gain or loss), and by requiring that the gains or losses be on income account.

If a sponsor that was a financial institution invested in the fund directly, the fund itself might fall into the definition of "financial institution" for the purposes of sections 142.2 to 142.6. This is because the definition of "financial institution" in subsection 142.3(1) includes a partnership more than 50 percent of the fair market value of all interests in which are held by one or more financial institutions. If a sponsor that was a financial institution (or a corporation controlled by such a sponsor) invested in the fund directly together with other financial institutions, it could subject the fund to the mark-to-market regime. This would negate the benefit of capital gains treatment except to the extent that the fund held shares in which it had a "significant interest" (generally, 10 percent or more of the votes and value of the corporation), prescribed property (which in this context would probably include shares of a "qualified small business corporation" within the meaning of draft regulation 9001(2)), or, in certain circumstances, "specified debt obligations" (loans, mortgages, bonds, notes, debentures, agreements of sale, and most other types of debt other than those expressly excluded).[74]

To avoid the fund's characterization as a financial institution, sponsor banks and their controlled affiliates normally invest side by side with the main fund. Other financial institutions may also have to invest separately if the 50 percent test would be offended. As a result, such entities make a direct investment in the relevant asset and enter into a parallel investment agreement with the fund to regulate the terms and conditions on which the investment is made. In effect, the agreement bridges the investment with that of the main fund, ensuring that it will be dealt with and disposed of on the same terms as if it had been acquired by the fund.[75]

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74 See the definition of "mark-to-market property" in subsection 142.2(1). The definition provides an exception for shares in which a taxpayer has a "significant interest," prescribed properties, and, in certain circumstances, "specified debt obligations." The terms "significant interest" and "specified obligation" are defined in section 142.2(1); what constitutes prescribed property for the purposes of paragraph (e) of the definition of "mark-to-market property" in subsection 142.2(1) is set out in draft regulations 9000 to 9002.

Note that the term "significant interest" applies to a "taxpayer." Although it is clear that a partnership can be a "financial institution" within the meaning of subsection 142.2(1), it is less clear that it is a taxpayer for these purposes. A partnership is not normally considered a "taxpayer" within the meaning of that term in subsection 248(1) of the Act. Where the computation of income is at issue, the CCRA has generally taken the view that paragraph 96(1)(a) permits the characterization of a partnership as a taxpayer. Although it appears that the mark-to-market rules in section 142.2 involve the computation of income and thus should result in a partnership being considered a taxpayer for these purposes, there is nothing directly on point to confirm this outcome. Conversations with the CCRA suggest that this is an issue it has never considered, and accordingly it has no position or policy with respect to the application of the term "significant interest" to a partnership.

75 Again, the use of a parallel investment or bridging agreement raises the question whether such agreement could be considered to create a partnership arrangement among the contracting parties. Although there are no published pronouncements on point, it is understood that the

Although the avoidance of financial-institution status is the goal of most funds, there are examples in the marketplace in which this has not been an issue. For example, in a 1997 ruling dealing with the status of a proposed qualified limited partnership, it was anticipated that the partnership would constitute a financial institution owing to the potential composition of the limited partners.[76] In that case, however, the partnership was organized primarily for the purpose of investing in debt securities of Canadian companies; the fact that the mark-to-market rules could apply to such assets was not material, given that income rather than capital gains would be generated.

Non-Resident Issues

If the Canadian fund has one or more non-resident members, a number of compliance issues arise. Although it is not necessary to establish a separate parallel entity (because the issues can often be managed without significant hardship), the potential benefit of using a parallel foreign partnership as a method of insulating non-residents from Canadian tax (see the discussion below under the heading "Avoiding Canadian Tax") makes a separate investment entity much more attractive.

Withholding-Tax Compliance

Pursuant to subsection 102(1), if a partnership has non-resident members, it is not a "Canadian partnership" for the purposes of the Act. Status as a Canadian partnership is relevant in determining whether part XIII tax is exigible in respect of dividends, interest, or other types of passive income received by a partnership from a Canadian resident. Paragraph 212(13.1)(b) provides that for part XIII withholding tax purposes, where a person resident in Canada pays or credits an amount to a partnership other than a Canadian partnership, the partnership is deemed, in respect of that payment, to be a non-resident of Canada. Accordingly, the payer of the interest or dividend to the partnership is required to withhold tax therefrom. Because paragraph 212(13.1)(b) does not deem the non-Canadian partnership to be a resident of any particular treaty country, the rate of Canadian non-resident withholding tax required to be withheld is 25 percent.

On an administrative basis, the CCRA may be prepared to reduce the withholding rate under paragraph 212(13.1)(b) to correspond with that of the treaty rate on the pro rata share of the interest or dividends paid to a treaty resident. Assuming that the partnership in question was owned 80 percent by Canadian partners and 20 percent by foreigners, withholding at the applicable reduced treaty rate would apply on only 20 percent of the interest or dividends paid by the partnership.[77]

CCRA has provided at least one comfort letter addressing this concern in the context of a bridging agreement between a qualified limited partnership and a parallel partnership entity.

76 CCRA document no. 9711923, October 3, 1997.

77 In order to obtain such a reduced treaty rate, written authorization must first be given by the payer's local Tax Services Office.

This position is consistent with the aggregate theory of a partnership referred to above. In the case of dividends, however, the CCRA has taken the position that although the reduced 15 percent dividend rate would be available to, for example, a US-resident partner, the 5 percent rate, which would apply if that partner owned at least 10 percent of the voting shares directly, would not.[78] The reasoning behind this position seems to be that the CCRA, notwithstanding its willingness to look through to the partner's beneficial entitlement to and ownership of the dividends, otherwise applies the entity theory and considers legal ownership of the relevant shares to reside with the partnership. This reasoning seems to contradict the CCRA's position with respect to the availability of the reduced 15 percent treaty rate on dividends. It is also contrary to the aggregate theory of a partnership. The relevant test for determining the availability of the 5 percent withholding entitlement under the Canada-US treaty contemplates "beneficial" ownership by the ultimate US corporate shareholder of at least 10 percent of the shares of the dividend-paying corporation. If one accepts that beneficial ownership of property does rest with the partners, it appears that the 5 percent rate should be available in these circumstances. As noted above, however, this is contrary to the CCRA's longstanding view, which favours the entity theory in this context.[79]

Section 116 Certificate Compliance

When a partnership that consists of one or more non-resident partners (that is, a non-Canadian partnership) disposes of "taxable Canadian property" (other than "excluded property"),[80] a section 116 clearance certificate is required. It is not clear who must obtain the certificate—the partnership or the non-resident partners. The issue is further complicated when such property is treaty-exempt. Under most of Canada's tax treaties, the primary right to tax dispositions of such property lies with the contracting state of which the alienator is a resident. However, residents of a contracting state generally encompass only those "liable to tax" in that state. Because a partnership is generally treated as a flowthrough entity (and thus is not liable to tax at the partnership level), a partnership is not generally considered a resident for treaty purposes.[81]

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78 "Revenue Canada Round Table," in *Report of Proceedings of the Forty-Third Tax Conference*, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992) 50:1-83, question 1, at 50:1-2.

79 This position is also contrary to the CCRA's stated position in the context of capital gains: see infra note 84.

80 A clearance certificate is not required for "excluded property." "Excluded property" includes a share in the capital stock of a corporation that is listed on a prescribed exchange, a unit of a mutual fund trust, and a bond, debenture bill, note, mortgage, or similar obligation.

81 For example, see CCRA document no. 9713120, May 20, 1997, wherein the CCRA stated: "With respect to associations that are partnerships it is our current practice, based on our understanding of the intent of the contracting states and the fact that the partners are the beneficial owners of the income, to look through a partnership and to allow a partner who is

As noted above, the CCRA takes the position that although a partner is viewed as owning a partnership interest, the partner is not viewed as owning a proportionate legal interest in the property of the partnership. On the basis of this interpretation, it seems to follow that the partnership is the alienator. As the alienator, it is required to obtain the section 116 certificate, but it is not eligible for the treaty exemption because it fails the residency test. Fortunately, this does not appear to be the CCRA's view. In the 1987 Revenue Canada Round Table,[82] the CCRA said that each partner and not the partnership must comply with the section 116 requirements. This seems to imply that each partner is considered to dispose of the partner's proportionate share of the partnership's property as though the partner had individual ownership in that property.[83] If this principle is extended to the disposition of taxable Canadian property that is treaty-exempt, each partner will be entitled to the benefit of any treaty relief on its share of the gain from the alienation of the property.[84]

Rollovers

Property of a non-Canadian partnership cannot be transferred to or from the partnership on a rollover basis. For a fund to be a qualified limited partner, it must not have acquired property on a rollover basis under subsection 97(2). Accordingly, this limitation is generally of little consequence in this context.

Avoiding Canadian Tax

As noted above, most venture capital funds file on the basis that the gains generated are on capital and not income account. Although this is the general practice in the industry, it has never been tested in the courts, and it is uncertain whether capital gains treatment would prevail in a CCRA challenge. This uncertainty has obvious implications for Canadian-resident investors, but it is of even more concern to non-residents. If an investor is resident in a treaty country, gains from the disposition of fund assets that are on capital account are normally exempt from Canadian tax under the treaty.[85] However, if the fund is considered to be carrying

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resident in the U.S. for the purposes of the Convention to claim the benefits of the Convention on his share of the partnership's income."

See also Howard J. Kellough and Peter E. McQuillan, "Canada," in International Fiscal Association, *International Tax Problems of Partnerships*, Cahiers de droit fiscal international, vol. 80a (The Hague: Kluwer Law International, 1995), 123-55, at 140-43.

82 "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Ninth Tax Conference*, 1987 Conference Report (Toronto: Canadian Tax Foundation, 1998), 47:1-103, question 87, at 47:47-48.

83 Where a large number of partners are involved, the CCRA also accepts one section 116 certificate, provided that a list of the names and addresses of all the partners is attached. The list must also indicate the percentage interest held by each non-resident partner.

84 The position that each partner is entitled to the benefit of any treaty relief on its share of partnership income has been confirmed by the CCRA on a number of occasions. For example, see CCRA document no. 9713120, May 20, 1997.

85 For US investors, care should be taken to ensure that no investments are made through a limited liability corporation that does not currently enjoy treaty protection under the Canada-US

on business in Canada and generates gains that were on income account, the non-resident will be subject to tax in Canada unless the income was not attributable to a permanent establishment of the non-resident in Canada.

Establishing a parallel foreign partnership for investors in these circumstances provides an additional line of defence against the possible imposition of such Canadian tax: it permits non-resident investors to use section 115.2 to escape characterization as "carrying on business in Canada," if the gains generated by the fund are found to be income rather than capital. Interestingly, the ability to use section 115.2 in this manner provides non-residents with a layer of protection that is not available to Canadian residents. This, when combined with the compliance issues discussed above, makes the use of a foreign parallel investment partnership a very attractive option.

Section 115.2

Section 115.2 provides a safe harbour rule to ensure that, if certain conditions are met, a non-resident person will not be considered to carry on business in Canada solely because a "Canadian service provider" provides "designated investment services" to the non-resident. This safe harbour rule is of particular relevance to non-residents who do not have the benefit of treaty protection and to treaty investors in funds where there is uncertainty about the income or capital nature of the gains generated.

1) "Designated investment services"

In order to benefit from the safe harbour rules, the Canadian service provider must provide to the non-resident only the following "designated investment services":

1. investment management and advice with respect to "qualified investments," regardless of whether the manager has discretionary authority to buy or sell;
2. purchasing and selling qualified investments, exercising rights incidental to the ownership of qualified investments such as voting, conversion, and exchange, and entering into and executing agreements with respect to such purchasing and selling and the exercising of such rights;
3. investment administration services, such as receiving, delivering, and having custody of investments, calculating and reporting investment values, receiving subscription amounts from and paying distributions and proceeds of disposition to investors in and beneficiaries of the non-resident, record keeping, accounting, and reporting to the non-resident and its investors and beneficiaries; and

treaty. Although the Department of Finance has indicated that Canada is considering granting benefits under the Canada-US treaty to limited liability companies in the context of negotiations for a future protocol, until such a provision is enacted ownership structures of this nature should be avoided.

4. if the non-resident is a corporation, trust, or partnership the only undertaking of which is the investing of its funds in qualified investments, marketing investments in the non-resident to non-resident investors.

The definition of "designated investment services" specifically separates marketing services (item 4 above) from administrative functions (item 3). The administrative functions are described in specific language and are not restricted to matters relating only to qualified investments. Such services can cover a very broad range of "back-office" functions.

2) "Qualified investment"

A "qualified investment" is defined in subsection 115.2(1) as

> (a) a share of the capital stock of a corporation, or an interest in a partnership, trust, entity, fund or organization, other than a share or an interest
>
> (i) that is either
>
> (A) not listed on a prescribed stock exchange, or
>
> (B) listed on a prescribed stock exchange, if the person or partnership, together with all persons with whom the person or partnership does not deal at arm's length, owns 25% or more of the issued shares of any class of the capital stock of the corporation or of the total value of interests in the partnership, entity, trust, fund or organization, as the case may be, and
>
> (ii) of which more than 50% of the fair market value is derived from one or more of
>
> (A) real property situated in Canada,
>
> (B) Canadian resource property, and
>
> (C) timber resource property;
>
> (b) indebtedness;
>
> (c) annuities;
>
> (d) commodities or commodities futures purchased or sold, directly or indirectly in any manner whatever, on a commodities or commodities futures exchange;
>
> (e) currency; and
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> (f) options, interests, rights and forward and futures agreements in respect of property described in any of paragraphs (a) to (e) or this paragraph, and agreements under which obligations are derived from interest rates, from the price of property described in any of those paragraphs, from payments made in respect of such a property by its issuer to holders of the property, or from an index reflecting a composite measure of such rates, prices or payments, whether or not the agreement creates any rights in or obligations regarding the referenced property itself.

Although there is significant overlap between the regulation 5000(7)(f) assets and the types of assets that constitute "qualified investments" for section 115.2 purposes, the latter category is broader in scope. For example, the term "qualified investment" includes an "interest in [a] partnership, trust, entity, fund or organization" (other than certain specified interests that derive more than 50 percent of their value from real property situated in Canada, Canadian resource property, and timber resource property). Also included are annuities; commodities or commodities futures; and options, interests, rights, and forward and futures agreements in respect of the foregoing types of properties.

3) "Canadian service provider"

The entity that provides these "designated investment services" must be a "Canadian service provider," which is defined to mean a corporation resident in Canada, a trust resident in Canada, or a Canadian partnership.

4) Conditions to be met under subsection 115.2(2)

The conditions in subsection 115.2(2) that a non-resident must satisfy vary according to whether the non-resident is an individual, a corporation, a trust, or a partnership.

A non-resident who is an individual (other than a trust) will not be considered to be carrying on business in Canada at any particular time solely because a Canadian service provider provides designated investment services to the non-resident, so long as the non-resident is not affiliated[86] with that Canadian service provider at that particular time.

If the non-resident is a corporation or trust (referred to herein as the "non-resident entity"), the following three conditions apply:

1. Pursuant to subparagraph 115.2(2)(b)(i), the non-resident entity must not have directed any promotion of interests in itself principally at Canadian investors[87] and must not have sold any such interests that are still outstanding to a person who was a Canadian investor both at the time of sale and at the time that the designated services are provided.
2. Pursuant to subparagraph 115.2(2)(b)(ii), the non-resident entity must not have filed any document with a public authority in Canada in accordance with securities legislation of Canada or of any province to permit the distribution of interests in itself to Canadian investors.
3. Pursuant to subparagraph 115.2(2)(b)(iii), if the non-resident entity was created more than one year before the designated investment services were provided to it by the Canadian service provider, the non-resident entity must establish that the total fair market value of the investments in the non-resident entity at that particular time that are beneficially owned by persons and partnerships (other than a designated entity[88] in respect of the Canadian

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86 See section 251.1. Under that section, persons will be affiliated with each other if certain elements of control exist among them. As noted below, the object of the test is to ensure that a reasonable measure of independence exists between the service provider and the non-resident who benefits from the protection of the rule.

87 The term "Canadian investor" is defined in subsection 115.2(1) to mean a person that the non-resident knows, or ought to know after reasonable inquiry, is resident in Canada.

88 Paragraph 115.2(3)(b) provides that a person or partnership is, at a particular time, a designated entity in respect of a Canadian service provider if the total of the fair market value, at the

service provider) that are affiliated[89] with the Canadian service provider does not exceed 25 percent of the fair market value of all investments in the non-resident entity at that particular time.[90]

If the non-resident is a partnership of which the non-resident person is a member, virtually the same condition as outlined in point 3 above applies—namely, pursuant to paragraph 115.2(2)(c), if the partnership was created more than one year before the designated investment services were provided to it by the Canadian service provider, the partnership must establish that the total fair market value of the investments in the partnership at that particular time that are beneficially owned by persons and partnerships (other than a designated entity[91] in respect of the Canadian service provider) that are affiliated[92] with the Canadian service provider does not exceed 25 percent of the fair market value of all investments in the non-resident entity at that particular time.[93]

The investment restrictions in subsection 115.2(2) are meant to ensure that a reasonable measure of independence exists between non-resident persons that benefit from section 115.2 and their service providers. Thus, by virtue of the condition in subparagraph 115.2(2)(b)(iii) and paragraph 115.2(2)(c), the safe harbour rule is not available in circumstances where more than 25 percent of the fair market value of all investments in the non-resident entity or partnership in which a non-resident person is a member is held by persons or partnerships that are affiliated with the service provider.

As noted above, the restrictions in paragraph 115.2(2)(c) are intended to be comparable to those found in subparagraph 115.2(2)(b)(iii). However, although the mechanics of the two provisions are comparable, the two rules differ substantively: paragraph (b) applies to limit investment in non-residents (in that paragraph, corporations and trusts) to which subsection 115.2(2) applies, whereas paragraph (c) does not restrict investments in non-residents that benefit from that subsection, but rather restricts the partnerships of which they are members.

The investment restrictions in subsection 115.2(2) are intended to ensure that a reasonable measure of independence exists between non-resident persons that benefit from section 115.2 and their service providers. Making section 115.2 available in those cases where a non-resident is a member of a partnership, of which 25 percent or more of the investments are held by persons and partnerships that are affiliated

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particular time, of investments in the entity that are beneficially owned by persons and partnerships (other than another designated entity in respect of the Canadian service provider) that are affiliated with the Canadian service provider does not exceed 25 percent of the fair market value, at the particular time, of all investments in the entity.

89 Supra note 86.

90 Subsection 115.2(3) sets out interpretive rules for applying this test.

91 Supra note 88.

92 Supra note 86.

93 Ibid.

with a service provider but not with the non-resident, does not appear to compromise this policy objective. In other words, it seems that the limitation in paragraph (c) may not be an accurate proxy for gauging the level of independence between any given non-resident and a service provider that supplies investment services to a partnership of which the non-resident is a member.

Given the foregoing, the government's policy objectives—to treat partnerships as flowthrough entities for the purposes of section 115.2 and to ensure that a reasonable measure of independence exists between non-resident persons who avail themselves of the benefit of this section and their service providers—are likely to be met by replacing the restriction in paragraph (c) with a limitation that better relates to the measure of independence between the non-resident person and the service provider that provides investment services to a partnership of which the non-resident is a member. In fact, this is precisely the approach recommended by the Department of Finance in a comfort letter dated June 4, 2002. In that letter, Finance stated that it intends to recommend two things: (1) that subsection 115.2(2) be amended so that a non-resident that is a member of a partnership which receives investment services will not be denied the benefit of section 115.2 because other persons or partnerships, which are affiliated with the service provider but not with the non-resident, hold more than 25 percent of the fair market value of the interests in the partnership; and (2) that, in keeping with the principle of applying section 115.2 at the partner level rather than at the partnership level, the 25 percent investment limit apply to the non-resident partners themselves. These amendments, if enacted, would apply to the 2002 and subsequent taxation years, at the non-resident's election.

As noted above, current paragraph 115.2(2)(b) prevents a non-resident person that is a corporation or trust from benefiting from the safe harbour rule if, at any time before the particular time that the designated investment services are provided, an investment in the non-resident was promoted principally to Canadian investors or sold to a person who at the time of the sale was, and at the particular time is, a Canadian investor, and still holds the investment in the non-resident corporation or trust. Prior to recent amendments, a similar restriction also applied to partnerships. Pursuant to Bill C-49,[94] effective for 1999 and subsequent taxation years, this limitation was eliminated for partnerships. Thus, a non-resident fund that has marketed or sold interests in itself to Canadian-resident investors is no longer prevented from using the provisions of subsection 115.2.

Under the pre-Bill C-49 version of the legislation, the safe harbour rule applied to a partnership only if it had no Canadian-resident members (that is, if the partnership was a "qualified non-resident"—a term that excluded any partnership in which one or more members were resident in Canada). As a result, a non-resident venture fund that had one or more Canadian-resident partners, or a Canadian-sponsored venture fund that had a Canadian-resident general partner, could not benefit from the protection afforded by the safe harbour rules.

94 Bill C-49, An Act To Implement Certain Provisions of the Budget Tabled in Parliament on December 10, 2001; first reading February 5, 2002; SC 2002, c. 9.

Bill C-49 amended section 115.2, applicable to 2002 and subsequent taxation years, to apply to all non-resident persons, including those who are members of a partnership with one or more partners resident in Canada. The result of this change is that the safe harbour rule no longer applies to a partnership per se, but rather to its constituent members. (In this regard, the definition of "qualified non-resident" in subsection 115.2(1) was repealed, and a number of consequential amendments were made to remove references to that term in the provision.)

As a result of the changes in Bill C-49, a foreign-sponsored venture fund with one or more Canadian-resident investors can take advantage of the safe harbour provisions of section 115.2. In the case of a Canadian-sponsored venture fund with a Canadian general partner, the result is less clear. Such a fund has ties to Canada not only through the use of a Canadian investment manager but also through the use of a Canadian general partner. Although the rules would technically apply to such a partnership, they would be of little assistance to a non-resident investor of the fund if it was found to be carrying on business in Canada because the partnership had a Canadian general partner. In other words, if the partnership was considered to be carrying on business in Canada not by virtue of a Canadian service provider's providing designated investment services but by virtue of the general partner's conduct, the safe harbour protection of section 115.2 would not be available.[95]

Notwithstanding that technical uncertainty, it is the department's view that section 115.2 would apply to protect a non-resident investor from being considered to be carrying on business in Canada if that investor was a member of a partnership with a general partner that was resident in Canada:

> [P]artnerships are not subject to a unique test to determine whether they are carrying on a business. The fact that an income-earning activity is carried on by a partnership does not, in and by itself, give rise to an assumption that an activity must be a business or that the partnership is carrying on a business. Whether any activity carried on by a partnership constitutes a business is, as in the case of any other entity, always a question of fact. Further, there is no unique test applied to partnerships to determine whether property is held or used in a business, or whether such property is "business property" in the context of our tax conventions. Again, CCRA confirms that it is always a question of fact whether property is so held or used to be business property.
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> Given the foregoing, it remains our view that no amendments are necessary to ensure that a non-resident limited partner who invests through a partnership with a general partner resident in Canada is not deemed to be carrying on business in Canada, or holding or using such property in the course of carrying on business simply because the investments are made through a partnership. Nor, where the conditions of 115.2 are met, would the partnership's use of a Canadian resident service provider by itself cause the nonresident partner to be considered to be carrying on business in

95 A partnership is a relationship among persons carrying on business in common with a view to profit. As set out in *Robinson*, supra note 48, where a partnership is considered to carry on a business, the limited partners of the partnership will be considered to be carrying on that business themselves, even though they have limited liability and take no part in the management of the business.

> Canada. The nonresident may, of course, be found on other bases to be carrying on business, and to be doing so in Canada. Section 115.2 is not intended to relieve a nonresident investor from Canadian tax in all conceivable situations but only to address the relatively narrow issue of retaining a Canadian service provider.[96]

As a result, a non-resident investor in a Canadian-sponsored investment fund with a Canadian general partner should be in the same position as a non-resident who invested in the underlying Canadian securities through a Canadian-managed account. Notwithstanding the Department of Finance's view, it is understood that lobbying efforts are underway to ensure such a result through legislative changes to section 115.2 and the addition of a specific provision to the Act, similar to section 253.1, to the effect that the acquisition and holding of a limited partnership interest will not result in such a member being considered to carry on any business or other activity of the partnership.

5) Transfer pricing

If a non-resident fund is structured to take advantage of the safe harbour rules of section 115.2, one should be mindful of the transfer-pricing consequences. Under subsection 115.2(4), if the Canadian service provider does not deal at arm's length with the "promoter" of the non-resident fund, the service provider is deemed not to deal at arm's length with the non-resident fund for the purposes of the transfer-pricing provisions of section 247. The "promoter" of a qualified non-resident that is a corporation, trust, or partnership is defined in subsection 115.2(1) as a person or partnership that initiates or directs the founding, organization, or substantial reorganization of the non-resident fund, or a person or partnership affiliated with such a person or partnership. The application of the rules in section 247, including the documentation and reporting requirements, are intended to ensure that transactions between the service provider and the non-resident fund take place on arm's-length terms.

CONCLUSION

Venture capital investments are attracting increasingly large pools of capital. As major institutional investors, such as pension funds, begin to take more active roles, the pressure to structure these investments to accommodate their needs will grow stronger. In the domestic context, this will require fund sponsors to ensure that such investments are not considered foreign property; in the foreign context, it will require sponsors to ensure that no Canadian tax on gains will be payable. Both these objectives are attainable, but they give rise to other issues which, if not properly managed, could result in unforeseen consequences to institutional and other investors. The challenge faced by fund sponsors is to minimize such risks without compromising the benefits that the structures are intended to obtain. It is hoped that the Department of Finance will clarify the areas of uncertainty in the near future and enable fund sponsors to better achieve these goals.

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96 Unpublished private technical interpretation from the Department of Finance, February 25, 2002.