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Tax Issues in Structuring Cross-Border Private Equity Funds

Ash Gupta,* Tim Wach,* Jeffrey D. Uffner,** and Susan R. Cohen**

PRÉCIS

Le présent article propose une vue d'ensemble des principales questions de fiscalité canadiennes et autres proprement américaines devant être étudiées dans la structuration de fonds d'investissement privé multiterritorial. On fait état aussi des formes juridiques qu'un fonds d'investissement privé peut revêtir, comme la société de personnes, la fiducie ou la société assortie de la personnalité morale, ainsi que de chacun de leurs avantages et inconvénients respectifs. D'importants éléments de structuration, comme la nature et la résidence des investisseurs éventuels dans le fonds ainsi que la nature des investissements prévus et l'administration compétente sont également étudiés. On relève aussi les principaux outils propres à la structuration des fonds d'investissement privé (et de certains autres fonds analogues). Ceux-ci comprennent les techniques spécialisées telles que le recours à une entité bloquante en amont ou en aval dans la structure d'investissement de façon à résoudre les questions telles que le revenu directement rattaché et le revenu imposable d'entreprise non liée qui présentent des risques pour les investisseurs ainsi que le recours à des entités de type « regroupeur » pour régler les problèmes de « rééquilibrage » qui se posent lorsqu'un fonds présente différentes dates d'échéance pour les investisseurs, notamment lorsque les fonds sont structurés avec plusieurs entités vendeuses. Le présent article porte également sur les questions liées à la convention fiscale entre le Canada et les États-Unis (1980) qui sont de première importance compte tenu de la forte tendance avec laquelle les fonds d'investissement privé canadiens se tournent vers les États-Unis pour trouver des investisseurs et des investissements non canadiens.

Bien que le présent article porte principalement sur la structuration des fonds d'investissement privé, les mêmes questions de structuration se posent à l'égard des fonds de couverture, des fonds d'infrastructure, des fonds de capital de risque, des fonds de rachat et d'autres fonds d'investissement analogues.

ABSTRACT

The authors provide an overview of the principal Canadian and certain US tax issues that are relevant in structuring multijurisdictional private equity funds. Alternative legal forms

* Of Gowling Lafleur Henderson LLP, Toronto. We thank Dalia Hamdy of Gowling Lafleur Henderson LLP for her significant contribution to this article.

** Of Stroock & Stroock & Lavan LLP, New York.

that a private equity fund may take, such as a partnership, trust, or corporation, are surveyed, and their respective advantages and disadvantages are considered. Key structuring issues, such as the nature and residence of target investors and the nature and jurisdictions of contemplated investments, are surveyed. As well, the principal tools unique to the structuring of private equity funds (and certain similar funds) are reviewed. These include such specialized techniques as inserting above-the-line and below-the-line blocker entities into fund structures to address risks to investors, such as effectively connected income and unrelated business taxable income. Another technique that the authors consider is the use of aggregator entities to address rebalancing issues that arise when funds have multiple closings for investors, particularly funds structured with multiple offering entities. The authors also address various considerations under the Canada-US tax treaty (1980) that are of importance because of the extent to which Canadian private equity funds look to the United States for non-Canadian investors and investments.

While the authors focus on private equity fund structuring, similar structuring issues arise for hedge funds, infrastructure funds, venture capital funds, buy-out funds, and other similar investment funds.

KEYWORDS: CROSS-BORDER ■ FUNDS ■ INVESTMENT ■ PARTNERSHIPS ■ TAX TREATIES ■ US-CANADA

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INTRODUCTION

Private equity funds have been in the spotlight for several years now. The private equity field continues to grow worldwide as funds increasingly attract cross-border investors, thereby expanding their capital base and enhancing the size of the investments they attract. Funds are consistently making acquisitions in more than one jurisdiction and acquiring target entities with multinational operations. Needless to say, these funds face many cross-border tax issues.

In this paper, we provide an overview of the principal Canadian tax issues that are relevant when structuring multijurisdictional private equity funds. In the first part, we survey the landscape of the world of private equity funds. In the second part, we consider the various legal forms that a private equity fund may take. The third part is devoted to an analysis of the principal Canadian tax considerations in structuring cross-border private equity funds; here we pay particular attention to the specialized techniques of inserting blockers and aggregators into the fund structure. In the fourth part, we discuss several issues arising from the Canada-US tax convention[1] that are of particular importance because Canadian private equity funds typically look to the United States for non-Canadian investors and investments. Finally, we conclude with a discussion of the relevant aspects of the foreign investment entity rules. While this paper is focused on the structuring of private equity funds, it addresses issues that also arise in the context of hedge funds, infrastructure funds, venture capital funds, buyout funds, and other similar investments.[2]

THE LANDSCAPE

Private equity fund investment strategies typically involve significant investment positions in unlisted corporate entities for long periods of time. The largest investors are tax-exempt pension funds. They have significant assets, but generally limited capital deployment opportunities; accordingly, pension funds have looked to private equity investments as a key component of their diversified investment strategies. Increasingly, Canadian tax-exempt funds invest outside Canada, while non-Canadian tax-exempt funds look to Canadian private equity investment opportunities.

While it may seem counterintuitive that tax planning is important to tax-exempt entities, tax leakage is in fact a significant concern because every dollar of tax paid reduces the return to the investors. Minimizing tax in cross-border situations is often challenging since an entity that is tax-exempt in its home jurisdiction may not enjoy the same status elsewhere.

Finally, it is not simply tax leakage that is of concern in structuring a private equity fund. Equally important are issues such as foreign tax-reporting obligations, which

1 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein referred to as "the Canada-US treaty"). The Protocol to the Canada-US treaty, signed on September 21, 2007, came into force on December 15, 2008 and is herein referred to as "the fifth protocol."

2 Recent papers dealing with particular Canadian income tax issues in the private equity sphere include Greg Boehmer and Andy Tse, "Leveraged Buyouts and Private Equity: Private Equity Structures," in *Report of Proceedings of the Fifty-Ninth Tax Conference*, 2007 Conference Report (Toronto: Canadian Tax Foundation, 2008), 9:1-22; Paul K. Tamaki, "Leveraged Buyouts and Private Equity: Structuring the Acquisition," ibid., 10:1-14; and Monica Biringer, "Leveraged Buyouts and Private Equity: Selected Issues in Debt-Financing the Acquisition," ibid., 11:1-23.

most pension funds are keen to avoid, and the preservation of benefits under various tax treaties or the domestic laws that govern certain foreign entities.

LEGAL FORM OF THE FUND

Limited Partnerships Are Most Common

The predominant form of a Canadian private equity fund is the limited partnership. Unlike a general partnership, where all partners are entitled to participate in the partnership's ownership and management and where each partner assumes unlimited liability for the partnership's liabilities, a limited partnership distinguishes between the partners that manage the business and the partners that merely invest capital in it. The general partners are subject to unlimited liability for the debts of the partnership, while the limited partners are liable only to the extent of their capital contribution, as long as they refrain from participating in the management of the business. Investors in private equity funds are typically limited partners.

From a tax perspective, the principal advantage of a limited partnership is fiscal transparency, which avoids taxation of the fund itself. Pursuant to section 96 of the Income Tax Act,[3] a partnership is required to compute its income or loss from each of its activities as if it were a separate taxpayer resident in Canada and as if its taxation year were its fiscal period; however, each item of income or loss is passed through to its partners in accordance with the terms of the governing partnership agreement for inclusion by the partners in computing their own income or loss for Canadian tax purposes.[4]

Limited partnerships receive similar treatment under the tax regimes of most of Canada's principal trading partners.[5] However, when a limited partnership's activities cross international borders, they expose the partners to potential tax liabilities and tax-reporting obligations in foreign jurisdictions. These liabilities and obligations are most likely to arise if the limited partnership's activities encompass the carrying on of a trade or business in a foreign jurisdiction.

Why Not Use a Trust?

In Canada, trusts are most often used as collective investment vehicles in the mutual fund industry. However, the tax treatment of trusts is usually unattractive for private

3 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act").

4 Subsection 96(1). This generalization is subject to a number of more specific rules, such as the at-risk rules, that can restrict the extent to which partnership income or losses can flow out to limited partners, as well as the anti-abuse rule in section 103. See generally, Laura J. Stoddard, "Clarification Required for Application of At-Risk Rules," Current Cases feature (2002) vol. 50, no. 5 *Canadian Tax Journal* 1690-94; and Edwin C. Harris, "The 'At-Risk' Rules for Limited Partnerships," in *Report of Proceedings of the Thirty-Eighth Tax Conference*, 1986 Conference Report (Toronto: Canadian Tax Foundation, 1987), 26:1-26.

5 See Organisation for Economic Co-operation and Development, *Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation no. 6 (Paris: OECD, 1999), 69-129.

equity funds. The potential liability for part XII.2 tax[6] as well as exposure to the 21-year deemed disposition rule[7] generally make trusts unappealing as the primary component of a fund structure. Moreover, the use of trusts in a fund structure tends to make exit strategies, both from investments and for investors, more complex, largely because a trust is taxable in its own right, even though it can generally flow income out to its investors to be taxed in their hands.[8]

However, many of the issues that arise through the use of a standard trust can be avoided if the trust qualifies as a mutual fund trust.[9] For example, a mutual fund trust is not subject to part XII.2 tax, nor is it subject to the 21-year deemed disposition rule. For these reasons, most income funds and royalty trusts, as well as most real estate investment trusts, are structured to qualify as mutual fund trusts. Unfortunately, private equity funds have difficulty in meeting the tests for qualification as mutual fund trusts. In order to qualify as a mutual fund trust, a trust must satisfy prescribed conditions relating to the dispersal of the ownership of its units: it must have completed a lawful distribution of its units to the public, and there must be *at least* 150 beneficiaries of the trust, each holding at least one block of units;[10] a trust must also qualify as a unit trust.[11] Generally, the most common form of unit trust requires that the units of the trust be redeemable on demand by the unit holders. Each of these conditions has proven problematic for most private equity funds.

Multiple Partnership Structures

If a fund sponsor intends to attract investors from many jurisdictions, it is not unusual for a private equity fund to take the form of two or more limited partnerships, known as "multiple partnerships" (or sometimes "parallel partnerships"). A limited partnership is formed in Canada, and a parallel limited partnership is formed in a foreign jurisdiction. In its simplest form (we discuss the interposition of aggregators and

6 Part XII.2 tax is levied on a trust if it has one or more designated beneficiaries (as defined in section 210). The tax is levied on trusts with beneficiaries that are non-residents of Canada, non-resident owned investment corporations, and certain other trusts. In general terms, this tax is intended to prevent the use of trusts to reduce the rates of taxes for non-residents from certain Canadian-sourced income, such as business income or gains, as well as to minimize tax through the disposition of trust units between taxable and tax-exempt entities. See *Interpretation Bulletin* IT-342R, "Trusts—Income Payable to Beneficiaries," March 21, 1990; and Doug Richardson and Mike Munoz Blake, "Issues Involved in the Ownership of Canadian Income Trusts by Non-Residents and Pension Funds—The 2004 Budget Proposals" (2004) vol. 17, no. 1 *Canadian Petroleum Tax Journal*.

7 In general, in order to prevent the indefinite postponement of capital gains taxes through the use of long-term trusts, a trust is deemed to have disposed of and reacquired its assets every 21 years. It therefore realizes any accrued gains on these assets and any resultant tax liability. See subsections 104(4), (5), and (5.2).

8 A notable exception to flowthrough treatment is part XII.2 tax; see supra note 6.

9 The definition of "mutual fund trust" appears in subsection 132(6).

10 Regulation 4801.

11 The definition of "unit trust" appears in paragraph 108(1)(a).

blockers below), the Canadian limited partnership and the foreign limited partnership separately invest in the same investment portfolio. This investment structure is illustrated in figure 1. Although a multiple partnership structure may add considerable complexity to matters such as capital draws and measurement of investor returns, it is often adopted for the reasons outlined in part III below.

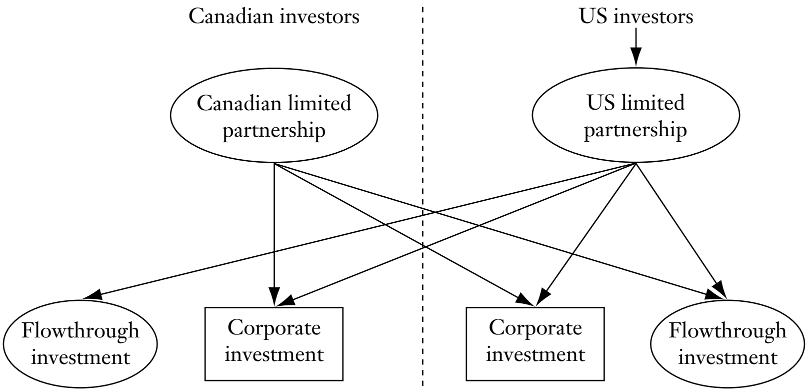
A multiple partnership also creates challenges in structuring the partnership agreements because these agreements must be drafted to fit together as separate pieces of a large puzzle. An agreement among the partnerships, often referred to as an "interfund agreement," is usually necessary and typically addresses matters such as the following:

- *The investment relationship between the partnerships*. Because a multiple partnership structure involves two or more separately created partnerships,[12] it ordinarily involves co-investments. The interfund agreement addresses aspects of the co-investment relationship, including the manner in which amounts received in respect of underlying investments are disbursed to members of the respective funds, the terms and conditions of additional capitalization, and the exit strategies. Each of the provisions of the interfund agreement is intended to bind the separate funds together as if a single fund were making the investments.
- *Rebalancing issues if multiple closings into the fund partnerships are contemplated*. One of the purposes of an interfund agreement is to address the mechanism by which the partnerships adjust their relative ownership interests in an underlying group of investments where the investments' value fluctuates between closings, and the partnerships draw down capital disproportionately (the concept of rebalancing is discussed in greater detail below).
- *Liability issues between the partnerships*. Another purpose of an interfund agreement is to ensure that a scheme exists to apportion the amount of any liability between the partnerships.
- *Issues relating to legal proceedings against third parties*. Provisions relating to these issues can be particularly complex. For example, if it becomes desirable for a legal action to be brought against a third party, it may be advantageous for the action to be brought in the name of only one of the partnerships.[13] An interfund

12 In our experience, the need to maintain the separate existence of each partnership that makes up a multiple partnership fund can lead to some interesting debates among tax advisers about whether the independence of the multiple partnerships will be honoured by various tax authorities. However, it is noteworthy that the Act does not contain a partnership equivalent to subsection 104(2), which is applicable to trusts and can cause two or more trusts to be collapsed and treated as a single trust if, among other things, substantially all of the trusts' property is received from one person and the trusts' income accrues to the benefit of the same beneficiary or group or class of beneficiaries.

13 This may be the case if one of the partnerships is located in the same jurisdiction as the third party or if the laws of the jurisdiction governing one of the partnerships allow a particular type of claim to be brought or a particular type of remedy to be sought that may be unavailable to the other partnership.

FIGURE 1 Simplest Multiple Partnership Structure



agreement must set out the manner in which the parties will collaborate, including the way in which they will fund the costs of the proceedings. These provisions may become problematic when the laws governing one of the partnerships prohibit a person from having a financial interest in a legal action brought by a third party.

An interfund agreement can become even more complex if a fund involves more than two partnerships, each situated in different jurisdictions.

To summarize, the most common form of legal structure for a Canadian private equity fund is the limited partnership. From a tax perspective, limited partnerships are preferred because of their fiscal transparency; trusts are less suitable for various reasons, including the potential application of part XII.2 tax and the 21-year disposition rules. Cross-border funds often use multiple partnerships structures. In the following part of this paper, we expand on the multiple partnership structure by reviewing the various factors that must be considered when structuring a cross-border fund.

STRUCTURING CONSIDERATIONS

When structuring a cross-border private equity fund, the two most significant guiding principles from a tax perspective are (1) the minimization of tax leakage, whether foreign or domestic, and (2) the insulation of investors from direct tax liability and reporting obligations outside their jurisdictions of organization or residence. To incorporate these principles, the main factors to be considered include: (1) the residence of prospective investors, (2) the need to use blocker entities in the fund structure, and (3) the rebalancing of multiple funds through the use of aggregator entities.

Residence of Investors

The first key consideration in fund architecture and design is the residence of prospective investors. If prospective investors include both Canadian and non-Canadian residents, it is important that the primary fund vehicle for Canadian investors maintain Canadian partnership status, at least with respect to Canadian investments.

Section 102 of the Act defines a "Canadian partnership" as a partnership all of whose members are resident in Canada at the relevant time. In this regard, any reference to a person who is a member of a particular partnership includes all members of another partnership that is itself a member of the particular partnership.[14]

It should be noted that the test for whether a partnership constitutes a Canadian partnership is a snapshot or "point in time" test. Therefore, it is possible to purify a partnership that fails to meet the definition at any time by either removing any non-resident members of the partnership or, subject to the application of the general anti-avoidance rule, restructuring the holdings of these members through the use of one or more blocker entities, as discussed below.

Canadian partnership status is relevant in a number of provisions of the Act. One key provision is subsection 97(2), which contains certain elective provisions that allow property to be transferred to a Canadian partnership on a tax-deferred rollover basis. The existence of even one non-resident partner at the time of transfer results in noncompliance with subsection 97(2), and consequently renders the partnership ineligible to make an election. Any asset transfer to the partnership is then governed by the more general provision in subsection 97(1), and is deemed to take place on a taxable basis at fair market value. In addition, the applicability of the special rules in subsection 98(3), which provide a tax-free rollover of assets from the partnership to its partners on the termination of the partnership, is limited to Canadian partnerships.

Another significant provision is paragraph 212(13.1)(b), which provides that where a person resident in Canada pays an amount to a partnership that is not a Canadian partnership within the meaning of section 102, the partnership is deemed to be a non-resident person for the purposes of part XIII. Accordingly, the Canadian resident payer is obliged to withhold any applicable non-resident withholding tax under part XIII, including tax on amounts that are ultimately allocable to Canadian resident members.[15] Withholding on all payments is required, even if the interests of non-resident members in the partnership are negligible. Canadian resident members

14 The Canada Revenue Agency (CRA) has consistently taken the position that where there are two or more tiers of partnerships and an upper-tier partnership is a partner of a lower-tier partnership, in determining whether that lower-tier partnership is a Canadian partnership for the purposes of section 102, each partner of the upper-tier partnership is considered to be a partner of the lower-tier partnership. See, for example, CRA document no. 9121825, February 3, 1992.

15 In these circumstances, it is interesting to note that the CRA's administrative policy regarding amounts paid to non-Canadian partnerships allows the payer of amounts to withhold at any reduced rates applicable pursuant to an income tax treaty or convention in respect of a non-resident partner's pro rata share of the amount of the payment. See, for example, CRA document no. 2004-0074241E5, July 19, 2005. However, the policy still requires full withholding at the domestic 25 percent rate in respect of any Canadian resident's pro rata share of the amount of the payment (see *Interpretation Bulletin* IT-81R, "Partnerships—Income of Non-Resident Partners," May 6, 1976).

can have their proportionate share of these withholdings applied against their part I tax liability or refunded to them.[16] Nevertheless, both the cash flow impact and the administrative impact is unattractive to all Canadian resident members, particularly tax-exempt members, of a partnership that is not a Canadian partnership.

Use of Blockers

The fiscally transparent nature of limited partnerships may entail certain disadvantages that should be noted. For example, transparency may create tax-reporting obligations in Canada for non-Canadian investors, or may cause unrelated business taxable income (UBTI) for US tax purposes to flow through to US tax-exempt investors. UBTI is income from a substantially unrelated trade or business that is regularly carried on by a tax-exempt entity, and can include certain debt-financed income (even if this income is passive, as in the case of dividends or interest). UBTI is taxable in the United States for a US tax-exempt entity, and can be taxable in the United States for a non-US entity if the income is derived from US sources or connected to a US trade or business. Concerns about UBTI often lead to the strategic placement of blockers within a fund structure.

The term "blocker" is not defined in the Act or the US Internal Revenue Code.[17] It is used to refer to any entity that is interposed into a fund structure for the purpose of blocking undesirable tax effects to the investor or the fund that arise as a result of the identity of the investor or the nature of the underlying investment; alternatively a blocker entity is interposed to block certain types of income (such as UBTI) from flowing through to investors. Blockers may be inserted above the primary fund vehicle (in which case they are called "above-the-line blockers") or below the primary fund vehicle (in which case they are called "below-the-line blockers") to achieve the desired result.

No standard form of blocker is used in all situations. The type of entity that is chosen in the context of a particular fund structure depends on the nature of the tax effect that is sought to be blocked.

Above-the-Line Blockers

Above-the-line blockers are typically inserted above the primary fund architecture for the purpose of (1) insulating the fund from the effects of a particular investor or (2) blocking the effect for a particular investor of investments that are made by or underneath the fund.

Strictly speaking, above-the-line blockers are not part of the architecture of a fund. Rather, they are usually inserted into a fund's structure by an investor either because the investor has concerns that emanate from the fund's structure as presented to the investor or because the investor is required to use these blockers as a condition of investing in the fund. Above-the-line blockers can be established by or for particular investors without affecting the tax treatment of the fund for other investors.

16 See *Information Circular* 77-16R4, "Non-Resident Income Tax," May 11, 1992, paragraph 68.

17 Internal Revenue Code of 1986, as amended (herein referred to as "the Code").

When structuring a fund, it is interesting to note the considerations that are taken into account by the fund sponsor in determining what below-the-line blockers, if any, will be incorporated into the fund structure. In general, this dynamic revolves around the conflict that the fund sponsor faces in wanting to make its fund attractive to as many potential investors as possible but at the same time wanting to reduce costs and complexity. Some sponsors go to great lengths to protect investors by building below-the-line blockers into the fund's structure, while others refuse to provide any below-the-line blockers. Although below-the-line blockers may make a fund more attractive to some investors by obviating certain tax risks, these blockers invariably have costs, such as administrative costs and the potential for tax leakage.

Faced with a fund structure that does not incorporate all the below-the-line blockers that it may prefer, an investor must then consider whether it will itself insert an above-the-line blocker. A situation in which an above-the-line blocker is typically used by an investor occurs when a Canadian pension fund invests in a US fund and the fund sponsor is unwilling or unable to provide assurances that the fund will not generate effectively connected income (ECI).[18] In such a case, it is common for the pension fund to effect the investment through a corporation that qualifies for tax-exempt status under paragraph 149(1)(o.2). In this way, any ECI that might otherwise flow up from the US fund will rest with the corporation, rather than flow up to the pension fund itself. Of course, the investor will want to ensure that the insertion of the blocker does not result in untoward tax results. A corporation that qualifies under paragraph 149(1)(o.2) is not only tax-exempt in Canada, but is generally entitled to all the benefits of the Canada-US treaty that are enjoyed by the Canadian pension fund itself.[19]

An example of a situation in which above-the-line blockers are employed because of requirements imposed by a fund arises when a Canadian fund is structured as a partnership and wants to qualify as a Canadian partnership for the purposes of the Act.[20] In this case, it is not unusual to see the interposition of a Canadian corporation between a foreign investor and the Canadian fund that is a partnership.

Below-the-Line Blockers

Below-the-line blockers are inserted into the ownership chain below the primary fund for the benefit of some or all fund investors in order to block the (usually adverse) tax consequences that would otherwise arise for these investors because of particular fund investments. For example, an investment in a fiscally transparent fund can give rise to direct tax liability and tax-reporting requirements in a foreign jurisdiction for an investor in a multijurisdictional fund. This exposure may arise if the fund invests in targets that are themselves fiscally transparent. In the US investment context, non-US investors are subject to tax liability and reporting obligations

18 ECI is discussed below under the headings "Below-the-Line Blockers" and "Addressing Tax Leakage in Below-the-Line Blockers."

19 See the discussion in notes 24 and 32 and in the accompanying text.

20 See the discussion above and supra note 14.

in the United States if they hold interests, directly or indirectly, in a fiscally transparent entity that earns ECI in the United States.[21] Generally, ECI consists of all income that is connected with the conduct of a trade or business in the United States, and includes any such income that is derived through partnerships or other fiscally transparent entities. Non-US investors ordinarily do not risk exposure to ECI, and therefore make their fund investments in or through a blocker entity.

In certain cases, the need for blockers can extend beyond tax liability and tax-filing exposures. For example, a Canadian governmental pension fund that invests in the United States can potentially be exempt from US tax under section 892 of the Code.[22] However, if the pension fund is a controlled commercial entity of the Canadian government, which can be the case if it engages in any commercial activities within or outside the United States, the pension fund is not entitled to any benefits under section 892 of the Code. For these purposes, a governmental pension fund is not treated as being engaged in commercial activities if it earns only income that would not be treated as UBTI if the fund were a US qualified pension trust. Accordingly, a governmental pension fund that earns UBTI from a private equity fund is not only required to file a US tax return and pay US taxes in respect of the UBTI; but, by reason of having become tainted as a controlled commercial entity, it also becomes disentitled to claim an exemption under section 892 of the Code in respect of its non-commercial income that would otherwise have qualified for exemption. For these reasons, if a Canadian governmental pension fund invests directly in a fiscally transparent entity that carries on a trade or business, there may be UBTI exposure and a potential loss of section 892 protection for the pension fund.

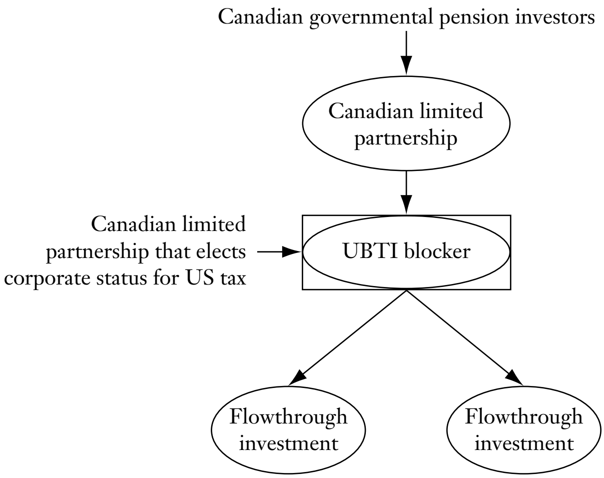
One method of addressing the risk of UBTI is to insert a hybrid partnership blocker into the structure. If, for example, a Canadian fund takes the form of a Canadian limited partnership, a UBTI blocker can be placed below the line in the form of a Canadian partnership that elects to be treated as a corporation for US income tax purposes. This structure is illustrated in figure 2. The insertion of the blocker in the form of the Canadian hybrid partnership preserves flowthrough treatment in Canada. Furthermore, the Canadian governmental pension fund is blocked from UBTI exposure on the non-US investments, and consequently will not become tainted as a controlled commercial entity for the purposes of section 892 of the Code by virtue of its investment in the fund. Provided that there are no US investments under the Canadian UBTI blocker, and the Canadian UBTI blocker otherwise does not engage in a US trade or business, US tax does not generally arise.

An alternative approach, in the case of a fund for Canadian investors in US investments, is the use of a US partnership that elects to be treated as a corporation for

21 See Code sections 871(b), 882, and 875.

22 The Code section 892 exemption generally extends to prescribed categories of income, including income from investments in the United States in stocks, bonds, or other securities, investments in the United States in financial instruments held in the execution of governmental financial or monetary policy, and US bank deposits. Income from US real estate is not generally exempt under section 892.

FIGURE 2 UBTI Blocker



US federal income tax purposes. Such a partnership preserves flowthrough treatment in Canada, but is taxed as a corporation in the United States. This type of blocker is subject to US (and possibly state and local) taxes on all its taxable income. The structure is illustrated in figure 3. With this type of blocker, and the blocker illustrated in figure 2, consideration should be given to the impact of the fifth protocol, which affects hybrid entities and is discussed in detail below.

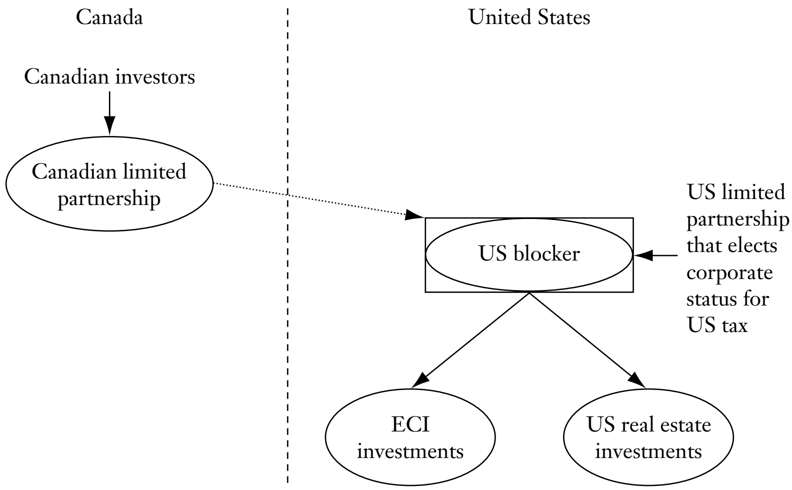
Depending on the characteristics of the investors, the nature of the investments, and the type of income generated, a blocker may not be necessary. For example, certain income may be exempt from domestic taxation in the foreign jurisdiction for some investors, or may be exempt by reason of a bilateral tax treaty. In the United States, for example, an exemption from domestic tax is available for portfolio interest.[23] Furthermore, the activities of a fund may not amount to conducting a trade or business in the United States. Article XXI of the Canada-US treaty also provides an exemption from US taxation for most interest and dividends received by a Canadian pension fund, as well as by corporations qualifying under paragraph 149(1)(o.2) of the Act.[24] Accordingly, the insertion of a below-the-line blocker for US investments may be unnecessary and excessively costly when these or other exemptions are available.

Notwithstanding the risk of tax leakage that arises with the use of corporate below-the-line blockers, the use of these blockers is not unusual. The standard steps to address tax leakage are discussed below.

23 See Code sections 871(h) and 881(c).

24 See notes 19 and 32 and the accompanying text for a discussion of these corporations. It is important to note a carve-out from the general article XXI exemption, which is found in

FIGURE 3 US Partnership Blocker



Addressing Tax Leakage in Below-the-Line Blockers

The most significant cost of using fiscally opaque below-the-line blockers is usually tax leakage. Fiscally opaque entities are treated as separate taxpayers and are therefore subject to tax. Accordingly, it is common to leverage fiscally opaque blockers with interest-bearing debt in order to reduce their taxable income. In structuring the debt, it is important to maximize the interest deduction available to the blocker and to minimize any withholding tax on the interest payments.

In the US context, for example, the structuring of any leverage in respect of a blocker must take into account potential interest deduction limitations under section 163(j) of the Code (the earnings-stripping rules applicable to related party interest payments) and other deduction limitations. Further, the interest generally must be structured to qualify for an exemption from withholding under the US statutory exemption for certain portfolio interest (this exemption does not apply to certain related party and other prescribed interest payments) or for an exemption or reduced rate of withholding under an applicable income tax treaty.[25]

Because many investors in private equity funds are tax-exempt in their home jurisdiction, it is logical to suppose that any tax leakage created by blockers would

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paragraph 3 of this article. In general terms, the US withholding tax exemption is not available "with respect to the income of a trust, company, organization or other arrangement from carrying on a trade or business or from a related person." The application of this carve-out to related persons can be a concern when a Canadian pension fund sets up its own US blocker or is a significant investor in a private equity fund. It is less of a concern when a Canadian pension fund is a relatively small investor in a private equity fund.

25 Such as article XXI of the Canada-US treaty. See also supra note 23.

be a great concern for investors. In fact, while leakage is a consideration, most sophisticated investors in cross-border funds recognize that their tax-exempt status in their home jurisdiction does not generally exist abroad. Even the US tax exemptions provided to Canadian pension funds under article XXI of the Canada-US treaty do not extend to ECI earned in the United States. Accordingly, a Canadian pension fund investing in the United States has a choice: (1) accepting direct liability for US tax on ECI, with this income flowing through the fund to the investor, or (2) interposing an above-the-line or a below-the-line blocker, even if this blocker is taxable. Accordingly, while tax leakage at the blocker level is often a significant concern, it generally does not prevent investors from using a blocker entity.

Rebalancing and the Use of Aggregator Entities

Private equity funds typically accept commitments for investments by investors over an extended period of time. Investors' obligations are referred to as "commitments" because investors rarely fund all of the amounts that they have subscribed for at the initial closing of their investment. Rather, investors commit to invest capital when the fund demands it, and these demands are usually timed to meet the needs of the fund on the closing of its various investments. The receipt of capital from an investor after the close of the initial investment is generally referred to as a "subsequent closing."

An issue that arises as a result of subsequent closings in a multiple partnership structure, particularly if a fund is partly invested, is the need to rebalance the interests of the investors. For example, assume that a fund is made up of two partnerships, a Canadian partnership in which Canadian investors invest, and a US partnership in which US investors invest. Assume further that the investors in the two partnerships have committed capital on the initial closing so that the Canadian partnership represents 30 percent of the value of the fund and the US partnership represents 70 percent of the value of the fund. If the fund has $1,000 in total commitments, the Canadian investors in the Canadian partnership have committed $300 in the aggregate, while the US investors in the US partnership have committed $700 in the aggregate. Now assume that immediately after the initial closing, the fund makes its first investment (in the amount of $100) in a private Canadian corporation, so that the Canadian partnership holds a 30 percent interest in that investment (valued at $30) and the US partnership holds a 70 percent interest in the investment (valued at $70).

Assume further that after these initial steps, the fund sponsor continues to solicit commitments from additional investors. Six months after the closing with the initial investors, there is a second closing with the new investors. On the second closing, new Canadian investors commit an aggregate of $100, while new US investors commit an aggregate of $900. The aggregate of all commitments to the fund is now $2,000. Canadian investors have committed a total of $400, while US investors have committed a total of $1,600. If a new investment is made by the fund (for example, in a US private corporation), it will be purchased 20 percent by the Canadian partnership and 80 percent by the US partnership.

The fund's initial investment in the Canadian private corporation, however, is still held 30 percent by the Canadian partnership and 70 percent by the US partnership.

The fund must then rebalance the relative interests of the two partnerships in the first investment to reflect the new overall commitment percentages of the two partnerships.

The means by which rebalancing is accomplished depends on the structure adopted for the fund. In the above example, the two partnerships may hold their respective interests in the first investment directly. On the second closing, in order to effect the necessary rebalancing, the Canadian partnership can simply transfer a portion of its interest in the first investment to the US partnership. Using the numerical examples above, the Canadian partnership transfers a 10 percent interest in the Canadian private corporation. However, this transfer may give rise to a taxable transaction in the investor's jurisdiction, in the jurisdiction of the investment, or in both jurisdictions.

In the above example, where the first investment takes the form of an interest in a Canadian private corporation, the transfer of an interest in this investment from the Canadian partnership to the US partnership is a taxable transaction for the Canadian partnership and its investors. If, contrary to the facts set out above, the rebalancing reflected a decrease in the relative interest of the US partnership in the fund, the rebalancing might also give rise to compliance obligations under section 116 of the Act. In addition, the rebalancing would give rise to a taxable transaction for the US investors in the US partnership.

A common approach to addressing anticipated rebalancing issues is to insert aggregator entities into the fund structure below the primary fund entities. This is done at the time that the fund is established and before any investments are made. An aggregator is a tax transparent entity through which the primary fund entities invest, and usually takes the form of a limited partnership. In Canada, however, it may take the form of a general partnership in order to alleviate concerns about the potentially adverse impact of the at-risk rules on the flowthrough of limited partnership losses (including the potential disappearance of these losses if a tiered limited partnership structure is used),[26] or the impact of the negative adjusted cost base (ACB) rules.[27]

It is not unusual to insert a separate aggregator for each jurisdiction in which a fund has significant investments. The use of partnerships as aggregators is illustrated

26 In very general terms, under the at-risk rules, the extent to which losses sustained by a partnership during a particular fiscal period may flow out to a "limited partner," as defined for the purposes of these rules, is limited to the limited partner's "at-risk amount," again as defined for the purposes of these rules, at the end of the fiscal period. See subsections 96(2.1) to 96 (2.7) of the Act. In general, if the flowthrough of a limited partnership's losses during a particular fiscal period of the partnership is restricted by the application of the at-risk rules, these losses can be carried forward and used by the limited partner at the end of a subsequent fiscal period of the limited partnership, provided that the limited partner's at-risk amount has increased. However, these rules do not accommodate such a carryforward of restricted limited partnership losses if the limited partner is itself a limited partnership. In such a case, the restricted losses simply disappear. See generally, Stoddard, supra note 4, and Harris, ibid., for a discussion of this tiered partnership issue.

27 See subsection 40(3.1) of the Act.

in figure 4. If the fund has a number of subsequent closings with investors, it is likely that rebalancing must occur on every subsequent closing.[28]

If such an aggregator were inserted in the example of the fund that initially closed with 30 percent of the committed capital coming from Canadian investors through a Canadian partnership and 70 percent of the committed capital coming from US investors through a US partnership, the initial $100 investment in a Canadian private corporation would be structured as follows: the Canadian partnership would invest $30 of capital in the Canadian aggregator and the US partnership would invest $70 of capital in the Canadian aggregator. The Canadian aggregator would use the $100 to acquire the Canadian private corporation. Subject to the comments below regarding the *Stursberg* decision,[29] the use of a partnership as an aggregator in the manner illustrated in figure 4 facilitates rebalancing from a Canadian perspective, because the initial investment in the Canadian private corporation is held through the Canadian aggregator. Rather than the Canadian partnership selling a 10 percent interest in the first investment to the US partnership, as is necessary if no aggregator is used, rebalancing in respect of the initial investment held through the Canadian aggregator can be achieved if the US partnership makes a further capital contribution of $10 to the Canadian aggregator and the Canadian partnership withdraws invested equity of $10 from the Canadian aggregator. In this way, the US partnership's interest in the Canadian aggregator increases from 70 percent to 80 percent, and the Canadian partnership's interest in the Canadian aggregator decreases from 30 percent to 20 percent.[30] If the second investment is a US investment, the $10 withdrawn by the Canadian partnership is contributed to the US aggregator in order to achieve an 80/20 percent ownership ratio.

An issue that must be considered from a Canadian perspective when dealing with this form of rebalancing is whether there is a disposition by the fund partnership that reduces its interest in the investments of the fund. In other words, has the Canadian partnership disposed of its interest in the Canadian aggregator?

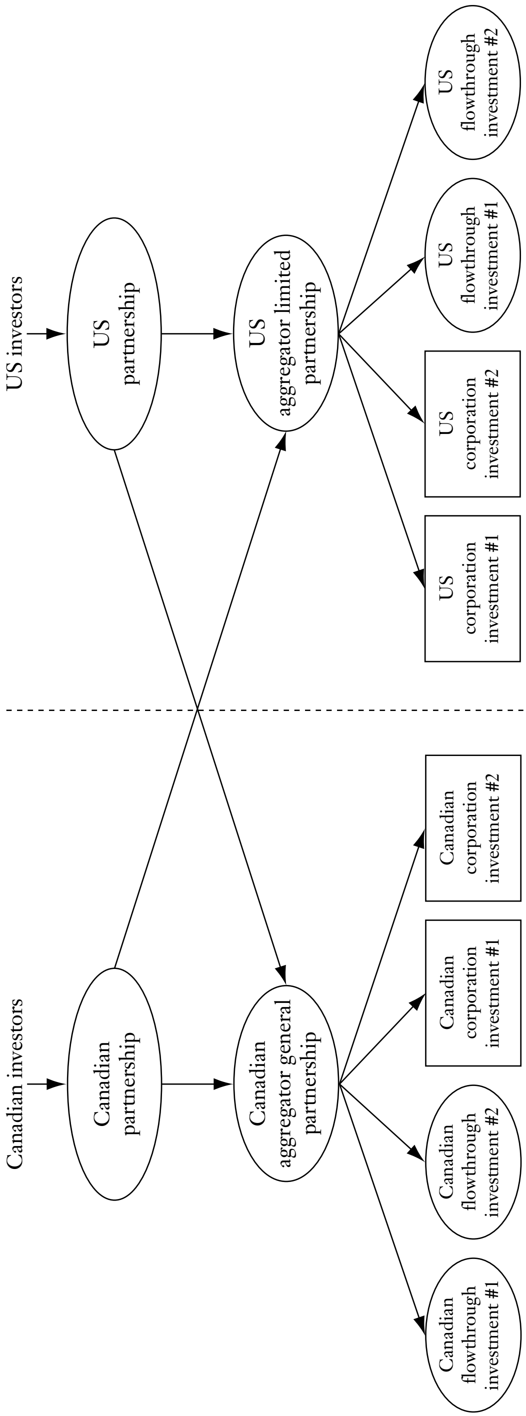
At first glance, it appears that a disposition should not occur. Partners usually rebalance their respective interests in a partnership without being considered to

28 Earlier we suggested that it is usually desirable to maintain Canadian partnership status under the Act when a fund is a partnership in which Canadian investors participate. See the discussion above under the heading "Residence of Investors." Accordingly, it is not unusual to see a below-the-line blocker in the form of a Canadian corporation inserted in the situation described in figure 4 between the US partnership and the Canadian aggregator general partnership. Traditionally, such a blocker has taken the form of a Canadian unlimited liability corporation. Similarly, blocker corporations may be placed within the fund structure to protect non-US investors from potential ECI exposure and certain tax-exempt investors from potential UBTI exposure.

29 Infra note 31.

30 This example is slightly simplistic because it assumes that the value of the initial investment is unchanged at the time of rebalancing. The potential change in value, as well as the time value of money (giving credit for earlier investment) makes actual rebalancing formulas more complicated.

FIGURE 4 Partnerships Used as Aggregators



have transferred interests from one partner to another—for example, a form of rebalancing occurs annually in virtually every professional partnership. However, a Canadian taxpayer must be sensitive to the potential application of the reasoning in the *Stursberg* case.[31] In *Stursberg*, an individual taxpayer received a payment from a partnership as a reduction of his capital interest in the partnership. At the same time, his partnership percentage was reduced from 40 percent to 15 percent. Coincident with these events, a corporation that was controlled by the taxpayer and that was also a partner contributed to the partnership the same amount that was distributed to the taxpayer, and the corporation also increased its interest in the partnership by the same 25 percent. The taxpayer reported the transaction as a distribution of capital that merely reduced the ACB of his partnership interest (in fact, causing it to go negative). The Canada Revenue Agency (CRA) challenged this characterization, and the Federal Court of Appeal agreed with the CRA, holding that the transaction was a taxable disposition of an "economic interest."

Notwithstanding the holding in *Stursberg*, the concept of a disposition of an economic interest has not been widely applied by the CRA. However, it seems that this concept is of greatest concern when a partner has a significant unrealized gain in its interest in a partnership, and a sale of this interest is effected in a manner similar to that employed in *Stursberg*.

Rebalancing is a little more complex with respect to the US component of a fund structure. Under the US disguised sale provisions, a partner's contribution of property to a partnership and certain related partnership distributions may be recharacterized as a sale of the property. The contribution of property or money to a partnership is generally not taxable under section 721 of the Code. Distributions of property or money are also generally non-taxable, except as provided in section 731(a)(1). Section 707(a)(2)(B) of the Code is a "substance over form" provision that dictates that if a related contribution and distribution are properly characterized as a sale or exchange of property, the transaction is to be recharacterized as a sale. These rules may result in a rebalancing being treated as a disguised sale of a partnership interest for US federal income tax purposes.

Summary

To reiterate, when structuring a cross-border private equity fund, practitioners must remain cognizant of the need to minimize tax leakage, whether foreign or domestic, and to insulate investors from direct tax liability and foreign reporting obligations. It is often most efficient for Canadian investors to invest through a vehicle that qualifies as a Canadian partnership under section 102 of the Act. Blockers may be used to eliminate the undesirable tax consequences that may arise as a result of the foreign residence of prospective investors and the form and jurisdiction of any target

31 *Stursberg v. The Queen*, 93 DTC 5271; [1993] 2 CTC 76 (FCA). See also, although arguably less relevant, *Vantem Holdings Ltd. et al. v. The Queen*, 98 DTC 1335; [1998] 1 CTC 2821 (TCC) and *Haro Pacific Enterprises Limited v. The Queen*, 90 DTC 6583 (FCTD). See also *The Queen v. Pinot Holdings Limited*, 99 DTC 5772; [2000] 1 CTC 258 (FCA).

investments. Aggregators may also be included in the fund structure to facilitate the rebalancing of the interests of investors in multiple partnership fund structures.

TREATY BENEFITS

A significant concern in any fund structure is the preservation of the tax treaty benefits that are otherwise available to investors. A number of issues arise in this context, including the impact that the interposition of fund entities between an investor and an investment can have on the availability of treaty benefits, and the potential application of and the general anti-avoidance rule (GAAR) in section 245 of the Act. Also of concern is the potential impact of the recently ratified fifth protocol to the Canada-US treaty on funds straddling the Canada-US border.

Issues Involving General Treaty Benefits

In discussing general treaty benefits, we refer to the usual reduced rates of withholding tax available under most tax treaties, such as reduced rates on dividends and interest, and the exemptions on gains realized on investments in one contracting state by residents of the other contracting state; we also refer to benefits available to tax-exempt entities, such as pension funds resident in one of the contracting states. For example, article XXI of the Canada-US treaty, in general terms, provides a complete exemption in one contracting state from withholding tax on interest and dividends derived from that state by a pension fund resident in the other contracting state. Moreover, these benefits are extended under article XXI to entities that are exempt from income tax in their contracting state of residence and that are operated exclusively to administer or provide pension benefits, or to earn income for the benefit of a pension plan. An example of such an entity is a corporation that is exempt from tax under part I of the Act by reason of paragraph 149(1)(o.2).[32]

32 Paragraph 149(1)(o.2) exempts from tax certain types of corporations that are involved with pension fund administration and investments, provided that all shares and rights to acquire shares in these corporations are owned by, or in certain cases held exclusively for the benefit of, one or more registered pension plans. The following categories of corporations may qualify for exemption from part I tax under paragraph 149(1)(o.2):

- corporations incorporated before November 17, 1978 solely in connection with, or for the administration of, a registered pension plan (subparagraph 149(1)(o.2)(i));
- corporations whose activities are limited to investing in real property or other permitted investments and certain other permitted activities in respect of real property that is capital property of the corporation, a registered pension plan, or another corporation (subparagraph 149(1)(o.2)(ii)); and
- corporations that have made no investments other than investments permitted under federal or provincial pension benefits standards legislation, provided that at least 98 percent of the corporations' assets consist of cash and investments, the corporations have issued no debt obligations and accepted no deposits, and the corporations have derived at least 98 percent of their income from the disposition of investments (subparagraph 149(1)(o.2)(iii)).

In order for corporations to qualify as being tax-exempt under any of these categories, all of their shares, and rights to acquire their shares, must be owned continuously since the later of

In many cases, the use of a fiscally opaque entity as a fund vehicle or as part of a fund structure[33] in the form of an above-the-line or below-the-line blocker can put these types of treaty benefits at risk. However, there are some exceptions to this general rule. First, corporations that are tax-exempt under paragraph 149(1)(o.2) are entitled to benefits under the Canada-US treaty that are similar to those available to Canadian pension funds. Second, treaty benefits may be preserved for Canadian residents in respect of US income, despite the interposition of a blocker if the income is earned through certain non-US hybrid entities that are treated as corporations for US federal income tax purposes, but that are "fiscally transparent" (as this term is defined in the US Treasury regulations under section 894 of the Code) under Canadian law.[34] Other than in the two foregoing circumstances,[35] the interposition of a corporation or a trust between an investor and an investment in a fund structure generally jeopardizes the availability of treaty benefits for an investor in respect of income earned through the corporation or trust.

On the other hand, the CRA generally looks through a partnership so that a non-resident entity that would be entitled to treaty benefits by holding a Canadian investment directly is also entitled to these benefits when holding an investment indirectly through a partnership.[36] The Internal Revenue Service similarly looks through a partnership, provided that the partnership is fiscally transparent under the laws of the non-US resident's jurisdiction. However, although a partnership vehicle is beneficial in preserving treaty benefits for investors, it also exposes them to potential tax-filing obligations in the foreign jurisdiction. This, subject to the discussion below regarding the fifth protocol, makes Canadian limited partnerships that are fiscally transparent for Canadian tax purposes and elect to be treated as corporations for US tax purposes very effective blockers. In many cases, these hybrid partnerships

November 16, 1978 and the date of incorporation by one or more registered pension plans, either directly or indirectly through one or more trusts or related segregated fund trusts all of whose beneficiaries are registered pension plans (subparagraph 149(1)(o.2)(iv)).

33 See the discussion above under the heading "Use of Blockers."

34 Hybrid entities are largely a product of US tax laws, which permit certain entities (with the exclusion of certain designated forms of corporate business entities) to elect their US tax classification—namely, partnership or corporation—without regard to their classification under non-US laws. For example, a Canadian limited partnership, which is otherwise fiscally transparent for Canadian tax purposes, may elect under US law to be treated as a corporation for US tax purposes. While this corporate status generally governs the application of US domestic laws to a hybrid entity, these laws allow treaty benefits to nevertheless be claimed by interest holders in the entity, provided that the entity is fiscally transparent under the laws of the interest holder's jurisdiction. See Treas. reg. section 1.894-1(d).

35 The use of corporations that qualify under paragraph 149(1)(o.2) is limited in this context. Because the shareholders of these corporations must be Canadian pension funds and certain other prescribed shareholders, these corporations can rarely be used as principal fund vehicles, and their usefulness as blockers is also restricted.

36 See CRA document no. 2004-0074241E5, July 19, 2005.

can block relevant US tax-filing obligations, while still preserving potential treaty benefits for Canadian investors.

Treaty Shopping and GAAR

The potential application of GAAR to deny the benefits of a treaty is generally of concern when a fund takes a corporate form (admittedly unusual) or when a corporate feeder[37] or corporate blocker is inserted into the structure (a far more common situation). For example, it is not unusual to insert a Luxembourg corporation feeder or above-the-line blocker for funds that invest in Canada. Luxembourg is a favoured jurisdiction in which to form a feeder because of the generally favourable terms of the Canada-Luxembourg tax treaty[38] and the very attractive features of Luxembourg's domestic tax system.[39]

When considering the possibility that the benefits of the Canada-Luxembourg treaty will be denied to such a corporation, practitioners must consider both the historic position of the CRA and the case law relating to the application of GAAR. Historically, the CRA has taken the position that GAAR is available to deny the benefits of a tax treaty in circumstances of "inappropriate treaty shopping."[40] However, recent jurisprudence regarding the application of GAAR[41] suggests that a fund sponsor may

37 The term "feeder" refers to an entity established to permit a certain class of investors to invest in a particular fund through a collective vehicle. For example, when a Canadian fund takes the form of a Canadian partnership, a feeder may be created to permit European investors to invest in the fund.

38 The Convention Between the Government of Canada and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Luxembourg on September 10, 1999. Particularly note paragraph 4 of article 13 of this treaty. Article 13 provides for the typical exemption from taxation in Canada for gains realized by a resident of Luxembourg, and the typical exception to that exemption for gains on shares of corporations and interests in partnerships or trusts that derive their value principally from immovable property located in Canada. However, paragraph 4 provides that for these purposes "immovable property" does not include property, other than rental property, in which the corporation, partnership, or trust carries on its business. This provision can be of particular importance in designing infrastructure funds.

39 Details of the domestic Luxembourg tax system are beyond the scope of this paper but include an effective participation exemption system as well as the ability to capitalize a Luxembourg intermediary corporation through hybrid securities, such as so-called preferred equity certificates (PECs), tracking PECs, or convertible PECs. In general terms, these securities are a form of equity share that permits the payment of tax-deductible (in Luxembourg) dividends to holders thereof.

40 See Canada Revenue Agency, *Income Tax Technical News* no. 30, May 21, 2004; "Revenue Canada Round Table: Canada-US and International Issues," in *Tax Planning for Canada-US and International Transactions*, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 22:1-32, question 11, at 22:9 (reproduced as CRA document no. 9314180, November 23, 1993); and CRA document no. 9522655, October 4, 1996.

41 *The Queen v. Canada Trustco Mortgage Co.*, [2005] 2 SCR 601.

be permitted to employ efficient tax structures if they are founded on purposes that are unrelated to Canadian taxes. In many cases, a strong argument can be made that there are valid reasons unrelated to Canadian taxes for establishing a vehicle to act as a feeder for certain investors in a private equity fund. If a feeder is, in fact, established principally for reasons unrelated to Canadian taxes, we believe that the current state of GAAR jurisprudence makes it difficult for the CRA to successfully challenge a decision to locate a feeder in a tax-favoured jurisdiction. This position is reinforced if investors in the feeder come from two or more foreign jurisdictions so that the fund has no natural or home jurisdiction.

Before the recent decision in *MIL*,[42] there may have been a greater level of concern that GAAR could successfully have challenged a structure involving, for example, several investors from the same jurisdiction investing in Canada through a feeder that was established in a third jurisdiction to which the investors had no particularly strong connection. Although some practitioners believe that *MIL* should give investors and fund sponsors great comfort in these circumstances, we caution against overconfidence. Aspects of the decisions of both the Tax Court of Canada and the Federal Court of Appeal are without question helpful in resisting a CRA challenge of a fund structure in which the fund or a feeder is located in a jurisdiction that has treaty and other fiscal advantages. We note in this regard the following comments of the Tax Court of Canada in *MIL*:

> I do not agree that Justice Iaccobucci's *obiter dicta* can be used to establish a prima facie finding of abuse arising from the choice of the most beneficial treaty. There is nothing inherently proper or improper with selecting one foreign regime over another. Respondent's counsel was correct in arguing that the selection of a low tax jurisdiction may speak persuasively as evidence of a tax purpose for an alleged avoidance transaction, but the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive. It is the *use* of the selected treaty that must be examined.[43]

However, given the pre-existing line of contrary authority, we suggest that other aspects of these decisions favour the exercise of caution.[44]

Fifth Protocol to the Canada-US Treaty

A significant recent development in the area of private equity fund structuring was the ratification of the fifth protocol to the Canada-US treaty, which was signed on September 21, 2007 and came into force on December 15, 2008.[45] The fifth protocol

42 *MIL (Investments) SA v. The Queen*, 2006 TCC 460.

43 Ibid., at paragraph 72, referring to *The Queen v. Crown Forest Industries Ltd.*, [1995] 2 SCR 802.

44 In particular, we note that the discussion by the Tax Court of Canada concerning the "misuse and abuse" aspect of the application of GAAR is not particularly persuasive and, strictly speaking, was obiter dicta.

45 The effective dates of various changes to the Canada-US treaty resulting from the introduction of the fifth protocol appear in article 27.

addresses a number of issues that have been outstanding for many years, including the treaty's treatment of US limited liability companies and their members. However, the introduction of a bilateral limitation on benefits (LOB), as well as the addition of new paragraphs 6 and 7 to article IV to deny residency in a contracting state to certain hybrid entities, are significant changes that directly affect fund architecture.[46]

The Canada-US treaty previously included an LOB provision that was enforceable only by the United States (in other words, only to deny treaty benefits to otherwise qualifying residents of Canada investing in the United States). The new LOB provision can apply both to residents of Canada investing in the United States and to residents of the United States investing in Canada. In particular, it is no longer sufficient for a taxpayer to be a resident of the United States in order to enjoy the benefits of the treaty; in general terms, the taxpayer must also be a qualifying person.[47] The term "qualifying person," as defined in new article XXIX A, is similar to the previous definition in the Canada-US treaty. In general terms, it includes the following persons resident in the United States (as defined in article IV of the treaty):

- a natural person;
- a company or trust whose "principal class" and any "disproportionate classes" (as defined in the fifth protocol) of shares or units are primarily and regularly traded on one or more "recognized stock exchanges" (as defined in the protocol); and
- a company more than 50 percent of whose shares, based on votes and value, are owned by qualifying persons.[48]

The introduction of the bilateral LOB provision is a radical change to the Canada-US treaty. However, in the context of structuring cross-border private equity funds, the greatest impact of the fifth protocol is likely to emanate from the changes intended to improve the status of US limited liability companies (LLCs) and the changes in article IV intended to address concerns about the use of hybrid structures.

Historically, the CRA has taken the position that US LLCs are corporations for Canadian tax purposes.[49] However, an LLC that is treated as a partnership or disregarded entity for US tax purposes is not subject to tax in the United States in its own

46 See also Boehmer and Tse, supra note 2, at 9:7, and Biringer, ibid., at 11:16, as well as Douglas A. Cannon, Marc Darmo, and Jeff Oldewening, "The Fifth Protocol to the Canada-US Income Tax Convention: A Review of Selected Provisions," ibid., 24:1-92, at 24:24.

47 Under paragraphs 3, 4, and 6 of the LOB provisions in the fifth protocol, a person that is not a qualifying person may nevertheless qualify for some of the benefits otherwise available under the Canada-US treaty.

48 This qualification in the fifth protocol includes specific anti-abuse rules dealing with debt substitute shares, disproportionate classes of shares, and a so-called base erosion rule. See the post-amble to subparagraph 2(e) in new article XXIX A.

49 At least to the extent that the CRA has reviewed LLCs created under different state laws. See, for example, CRA document no. 2001-0085845, January 29, 2002 (Tennessee LLCs); CRA document no. 9505641, November 27, 1995 (Kentucky LLCs); CRA document no. 9420605,

right. Accordingly, the CRA has taken the position that such an LLC is not resident in the United States for the purposes of the Canada-US treaty and therefore is not entitled to the benefits of the treaty.[50] The intended amelioration of this treatment is found in article 2 of the fifth protocol, which amends article IV of the Canada-US treaty by adding a new paragraph 6. Paragraph 6 generally has the effect of looking through a fiscally transparent LLC that is used to invest in Canada in relation to any member of the LLC that is a US resident, and potentially providing treaty benefits for such a member.[51] Accordingly, with the entry into force of the fifth protocol, US investors and private equity funds now have greater flexibility to use US LLCs as investment vehicles in connection with Canadian investments.[52] It is important to note, however, that this ameliorative affect applies only to investors in an LLC that are both US residents and qualifying persons. For others (generally non-residents of the United States, including residents of Canada), this change presents no improvement.

Unlike the ameliorative nature of the lookthrough provision that we have just described, the provisions contained in the fifth protocol that relate to the use of hybrid entities are restrictive. The latter provisions, which become effective beginning in 2010, appear to curtail the use of hybrid entities in certain fund structures, including many structures that most observers would not consider to be abusive. For example, the new anti-hybrid provision could have a significant impact on the use of Nova Scotia, Alberta, and British Columbia unlimited liability companies and corporations (ULCs). Currently, these entities are useful blockers in fund structures[53] because ULCs are not fiscally transparent for Canadian tax purposes but can elect to be treated as fiscally transparent or as disregarded entities for US tax purposes. For example, a ULC can be placed above a Canadian partnership and below US investors in order to maintain Canadian partnership status for the purposes of the Act[54] while maintaining flowthrough status for US tax purposes. They can also

October 12, 1995 (dealing with Michigan LLCs and discussing New York LLCs by way of comparison); CRA document no. 9416835, June 30, 1994 (Delaware LLCs); CRA document no. 9326015, December 17, 1993 (Texas LLCs); CRA document no. 9417505, October 25, 1994 (Florida LLCs); CRA document no. 2000-0053595, February 4, 2002 (Oregon LLCs); and CRA document no. 2001-0083545, January 29, 2002 (Ohio LLCs).

50 See CRA document no. 2003-0049781E5, January 8, 2004; CRA document no. 2005-0118521l7, February 14, 2006; and CRA document no. 2002-0133747, May 21, 2002.

51 We say “potentially” because it is still necessary for such a member to satisfy the “same treatment” requirements and the new LOB requirements in order to obtain the benefits of the treaty.

52 The approach taken in new paragraph 6 of article IV of the Canada-US treaty is consistent with the US treatment of entities that are fiscally transparent under the non-US laws applicable to their interest holders. See Treas. reg. section 1.894-1(d). The approach is also consistent with the provisions contained in the United States, Treasury Department, United States Model Income Tax Convention of November 15, 2006.

53 See the discussion above under the heading “Use of Blockers” for a detailed description of blocker entities.

54 See section 102.

shield non-Canadian fund investors from direct Canadian tax liability and tax-filing obligations. However, it appears that pursuant to new paragraph 7(b) of article IV of the Canada-US treaty, which is contained in article 2 of the fifth protocol, treaty benefits can be denied to US members or shareholders of a ULC that is fiscally transparent in the United States.[55]

Similarly, the fifth protocol provisions relating to the use of hybrid entities may significantly affect the use of US limited partnerships by Canadians who invest in the United States. A US limited partnership is treated as fiscally transparent in Canada, but it can elect to be treated as a corporation for US federal income tax purposes; such an entity is referred to in US tax regulations as a "domestic reverse hybrid entity." Since a domestic reverse hybrid entity is treated as a corporation for US federal income tax purposes, it can effectively shield Canadian investors from being considered to be engaged in a trade or business in the United States and accordingly can insulate these Canadian investors from any US tax (including branch profits tax) and filing exposure. However, it appears that new paragraph 7(b) of article IV of the Canada-US treaty, as contained in article 2 of the fifth protocol, also denies treaty benefits in respect of amounts received from the domestic reverse hybrid entity.[56]

This denial of treaty benefits goes far beyond the limitations that would apply to domestic reverse hybrids under US law in the absence of an overriding treaty provision. While domestic US law denies treaty benefits in respect of US-source income received by a domestic reverse hybrid, it affords treaty benefits in respect of payments made by a domestic reverse hybrid to its interest holders, with certain

55 See infra note 56.

56 It is clear that the denial of treaty benefits applies to deductible and non-deductible payments by both a Canadian ULC that is a wholly owned disregarded entity of a US resident for US tax purposes and a US domestic reverse hybrid that is treated as a wholly owned branch of a Canadian recipient for Canadian tax purposes. However, there is some uncertainty about whether the denial of treaty benefits applies to deductible payments (for example, interest and royalties) by a Canadian ULC or a US domestic reverse hybrid where the entity that makes the payment is treated as a partnership under the income tax laws of the payee's jurisdiction. The treatment of the deductible payment may be considered to be the same in certain respects, regardless of whether the paying entity is treated as a corporation or partnership for tax purposes. See United States, Staff of the Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada*, JXC-57-08 (Washington, DC: Joint Committee on Taxation, July 8, 2008), 103-4 (noting the uncertainty in this regard). Michael F. Mundaca, Treasury deputy assistant secretary for international tax affairs, served as the US Treasury Department's witness at the July 10, 2008 United States Senate Committee on Foreign Relations hearing on the fifth protocol and provided the following written response to additional questions for the record submitted by Senator Joseph R. Biden Jr. in this regard: "Although not specifically addressed in the Technical Explanation, the Treasury Department and Canada agree that subparagraph 7(b) does not apply to deny benefits to interest and royalty payments by an entity that is treated as a partnership by one country and a corporation by the other if the treatment of such amount by the country of the person deriving the income would be the same if such amount had been derived directly by such person (interest or royalties)." S. Exec. Rep. no. 15, 110th Cong., 2nd Sess., Annex II, at 145 (2008).

limitations applicable to related parties.[57] The full impact of the fifth protocol and approaches in dealing with this impact are still to be explored and determined.

ISSUES INVOLVING FOREIGN INVESTMENT ENTITIES

There is a considerable volume of literature concerning the proposed foreign investment entity (FIE) rules,[58] and a detailed review of these rules is beyond the scope of this article. In general terms and subject to certain exceptions, the FIE rules apply to deem that a Canadian resident taxpayer (other than an exempt taxpayer) has an income inclusion when the taxpayer holds a participating interest (other than an exempt interest) in a non-resident entity that is a FIE at the end of the taxation year of the non-resident entity. Where a Canadian resident taxpayer makes an investment through a partnership, the FIE rules are applied at the partnership level, and any resulting income is flowed through to the partners. Therefore, in the context of a Canadian private equity fund that is structured as a partnership, it is necessary first to determine whether any investment of the partnership can be characterized as a participating interest in a FIE, and second whether any of the exceptions to the FIE rules apply. The most significant exception to the FIE rules operates when a non-resident target entity is not a FIE at the end of its taxation year.

The charging provision in proposed subsection 94.1(3) of the Act applies only to an interest in a non-resident entity that is a FIE at the end of a taxation year of the non-resident entity. A non-resident entity is excluded from the definition of a FIE if the carrying value of all of the investment property of the entity is not greater than one-half of the carrying value of all of the entity's property. Also excluded from the

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57 See Treas. reg. section 1.894-1(d)(2). In his written response to additional questions for the record submitted by Senator Joseph R. Biden Jr. to Michael F. Mundaca, supra note 56, Mundaca recognized that "[t]he rule [of subparagraph 7(b)] is broader than an analogous rule in Treasury regulations issued pursuant to section 894 of the Internal Revenue Code." He further provided that "[t]he Treasury Department is aware that the scope of subparagraph 7(b) is potentially overbroad, especially in the case of non-deductible payments. The Treasury Department has been discussing, and will continue to discuss with Canada, whether to address this issue. The Treasury Department does not contemplate incorporating such a rule in future tax treaties." See S. Exec. Rep. no. 15, supra note 56, at 143. See also the January 29, 2008 letter submitted to the United States Department of the Treasury and the Internal Revenue Service on behalf of the New York State Bar Association Tax Section, 2008 *Tax Notes Today* 23-43, which comments on the treatment of hybrid entities under the fifth protocol and provides examples of non-abusive uses of hybrid entities that appear to fall within the limitations of the fifth protocol hybrid provisions.

58 Albert Baker and Grant Russell, "FIE Proposals Overview" (2007) vol. 15, no. 1 *Canadian Tax Highlights* 8; Robert J. Spindler and Scott Wilkie, "The Revised Foreign Investment Entity Rules," in *Report of Proceedings of the Fifty-Third Tax Conference*, 2001 Conference Report (Toronto: Canadian Tax Foundation, 2002), 23:1-22; and Eric Lockwood and Nick Pantaleo, "Foreign Affiliates and the New Foreign Investment Entity Rules," International Tax Planning feature (2003) vol. 51, no. 1 *Canadian Tax Journal* 539-68.

definition of a FIE is a non-resident entity whose principal undertaking is not an investment business. The concept of investment property in proposed subsection 94.1(1) generally includes passive investments, such as shares, debt, real estate, resource properties, commodities, and currency. Specifically excluded from this definition are properties that are used or held principally in a business (other than an investment business) that is carried on by the non-resident entity or by a related party. An investment business generally includes a business whose principal purpose is to derive income from property (such as dividends, rents, royalties, interest, or any similar return on investment), from the insurance or reinsurance of risks, from the factoring of accounts receivables, or from the disposition of "investment property" as defined. Whether or not the principal undertaking of a non-resident entity is an investment business can be determined only by reference to the facts and circumstances in each instance. However, an interest in a non-resident entity that carries on an active business that is not in the nature of an investment business (as is typically the case in most private equity target investments) is generally not a participating interest in a FIE for the purposes of the FIE rules. If, however, a particular target investment does not clearly carry on a non-investment active business, a close review of the FIE rules will be necessary. These exceptions may be difficult to apply to a fund-of-funds structure and, in either case, will require that practitioners carefully analyze all direct and indirect non-Canadian investments of the fund.

CONCLUSION

As is typically the case with cross-border investments, the tax issues that arise in structuring cross-border investment funds are many and complex. Moreover, they are constantly changing, and inevitably subject to ambiguity and differing interpretations. We have attempted to set out some of the ground rules for cross-border fund structuring, and hope that this article provides a constructive and thought-provoking analysis for tax advisers (including us) to work with in the future.