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Proposed Draft Legislation for Investment Limited Partnerships

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In this Update

- on September 8, 2017, the Department of Finance released draft legislation to amend the *Excise Tax Act* (Canada) (ETA) to deal with "Investment Limited Partnerships"
- impact of these changes on mutual funds or investment plans which use limited partnerships in their structure
- broad definition of "Investment Limited Partnership"
- the Draft Legislation has the potential to significantly increase the amount of unrecoverable GST/HST paid by many limited partnerships

On September 8, 2017, the Department of Finance released draft legislation to amend the *Excise Tax Act* (Canada) ("ETA"), including amendments to (a) in effect, deem general partners of certain newly defined "Investment Limited Partnerships" that provide management or administrative services (which are broadly defined to include asset management services, and would generally cover most of the activities performed by a general partner) to the limited partnership to be making a taxable supply to the limited partnership and (b) extend the application of the GST/HST rules applicable to selected listed financial institutions ("SLFI Rules") to such Investment Limited Partnerships (the "Draft Legislation"). These changes will likely have a significant impact on private equity, venture capital and hedge funds or other "investment plans" which use limited partnerships in their structure, as well as investors in such funds, but could also potentially affect many other types of businesses that use limited partnerships as holding entities.

Deemed supplies by the general partner to the partnership – New ss.272.1(8) of the ETA

Proposed new subsection 272.1(8) of the ETA sets out rules which deem the provision of management or administrative services by a general partner to an Investment Limited Partnership of which it is a member to be done by the general partner otherwise than as a member of the partnership and otherwise than in the course of the partnership's activities. The proposed new rules only apply to an "Investment Limited Partnership," the scope of which term is discussed below. The effect of the new deeming rules is to treat the provision of the management or administrative services as a separate taxable supply by the general partner to such a partnership for purposes of the ETA and, accordingly, subject to GST/HST.

In addition to having the effect of deeming the general partner to be making a taxable supply to the limited partnerships, the new deeming rules will also, in most circumstances, deem such supply by the general partner to be made for fair market value consideration, thereby ensuring that tax will be payable on the deemed supply. Specifically, the Draft Legislation causes existing subsection 272.1(3) of the ETA to apply such that where the management or administrative service is considered to have been acquired by the partnership for use or supply otherwise than exclusively in the course of commercial

activities of the partnership (which would generally be the case for an Investment Limited Partnership), the supply of the service to the partnership is deemed to be made for consideration equal to the fair market value of the service at the time the service is acquired by the partnership, as if it were acquired in an arm's length transaction. It should be noted that, in these circumstances, as existing subsection 272.1(3) currently reads, tax would be payable on the fair market value of the management and administrative services at the time the service is acquired by the partnership rather than on the actual amount paid or distributed to the general partner (i.e. partnership distributions) as and when such payment or distribution is made. This has two important valuation implications:

- In order to determine the fair market value consideration for their deemed taxable supply to Investment Limited Partnerships, general partners may well need to conduct (or obtain) transfer pricing-like studies of what third parties would charge similar limited partnerships for similar management or administrative service functions. In doing so, general partners will need to consider what relevance the amounts actually received by the general partner from the partnership, including various kinds of partnership distributions, may have in such a valuation exercise.
- The deemed fair market value consideration rule could cause valuation timing issues if amounts are paid to the partner in different periods than when the services are provided (i.e. amounts calculated as a percentage of profits which are payable at the end of a set period). It does not make sense to force Investment Limited Partnerships to determine what an arm's length party would charge for management and administrative services on a monthly basis in order to determine the amount of GST/HST payable by the partnership to the general partner without taking into account the amount actually received by the general partner. If the goal was to tax the amounts actually paid to the general partner at the time the amounts are paid, then revisions will likely be needed to the Draft Legislation to make this clear. To the extent that partnership distributions are relevant in determining the fair market value of the deemed supply (see previous bullet point), the timing issue may be particularly acute for some Investment Limited Partnerships that may not pay their general partners all distributions on a monthly basis.

The timing for the coming into effect of the new deeming rules means affected parties must take these rules into account immediately. New subsection 272.1(8) is proposed to apply in respect of the provision of a management or administrative service if any consideration for a supply of the service becomes due on or after September 8, 2017, or is paid on or after that day without having become due, or if all of the consideration for a supply of the service became due or was paid before that date if the supplier, on or before that day, charged, collected or remitted any amount as or on account of GST/HST in respect of the supply.

The new deeming rule has the potential to materially increase the amount of unrecoverable GST/HST paid by many limited partnerships. In many, if not most, funds organized as limited partnerships, such tax would be a partnership expense, which would, depending on the fund terms, typically be allocated among all the partners. In such cases, the true economic impact of this measure will, accordingly, fall as much on limited partners (fund investors) as general partners (fund sponsors).

Broad definition of Investment Limited Partnership

The Draft Legislation defines an Investment Limited Partnership to include certain limited partnerships whose primary purpose is to invest funds in property consisting primarily of financial instruments, including such a partnership where the partnership itself, or the arrangement or structure of which it forms a part, is represented or promoted as a hedge fund, investment limited partnership, mutual fund, private equity fund or venture capital fund or other similar collective investment vehicle. The language used in the Draft Legislation is very broad, and raises some interpretational issues as to when the Canada Revenue Agency will consider a limited partnership to form "part of" an arrangement or structure represented or promoted as an investment vehicle. In particular, the Draft Legislation is not clear whether the rule will apply only to situations where the limited partnership is an integral part of a fund structure, or will also apply to any limited partnership in which an investment vehicle has a substantial investment.

The definition of Investment Limited Partnerships also encompasses certain limited partnerships that are investment vehicles for, or are funding mediums for investing on behalf of, listed financial institutions. Thus, limited partnerships whose primary purpose is to invest funds in property consisting primarily of financial instruments will now have to determine whether their limited partners are listed financial institutions.

It should be noted that the Draft Legislation includes a specific rule which deems an Investment Limited Partnership to not be resident in Canada if at least 95% of all interests in such a partnership are held by members that are non-residents of Canada. In most cases, not being resident in Canada will result in most supplies made to the non-resident limited partnership being zero-rated. However, certain members of such a partnership that are non-resident trusts or non-resident limited partnerships are not treated as non-resident members for purposes of this determination. In particular, the exception would apply to a member that is a non-resident trust or non-resident limited partnership where the total value of the assets of the trust member in which one or more persons resident in Canada have a beneficial interest, or the total value of all interests in the limited partnership member held by persons resident in Canada, is more than 5% of the total value of all of the assets of the trust member or all interests in the limited partnership member, as the case may be.

Extension of SLFI Rules to partnerships

One of the effects of the Draft Legislation is to extend the application of the SLFI Rules to certain limited partnerships (specifically Investment Limited Partnerships), thereby addressing the uneven tax treatment afforded these partnerships relative to investment plans for GST/HST purposes.

Generally, financial service providers are neither able to register for GST/HST purposes nor entitled to claim input tax credits (ITCs) to offset GST/HST paid in respect of various inputs. Absent the SLFI Rules, financial service providers would have an incentive to locate in, or source goods and services from, non-HST jurisdictions (such as Alberta) in order to minimize their tax costs. As such, the SLFI Rules were adopted to remove the incentive for "investment plans" (as defined in the ETA) and certain other selected listed financial institutions to locate in a non-HST province and consequently pay only GST (as opposed to HST) on expenses such as management fees. This was accomplished by requiring the investment plans to calculate and adjust their GST/HST liability based on the residence of their investors, rather than the GST/HST actually paid or payable on input costs. Under the existing rules, an "investment plan" includes such entities as unit trusts, mutual fund trusts, mutual fund corporations, and registered pension plan trusts and corporations; but does not include partnerships.

Under the Draft Legislation, an Investment Limited Partnership would be treated similar to mutual fund trusts, mutual fund corporations and other investment plans. Such an Investment Limited Partnership would fall within the definition of a "distributed investment plan", and would be deemed for the purposes of the SLFI Rules to have a permanent establishment in any province in which it is qualified, under the laws of Canada or a province, to sell or distribute its partnership units and in any province where a person who holds units in the partnership is resident.

Conclusion

As the Draft Legislation has the potential to significantly increase the amount of unrecoverable GST/HST paid by many limited partnerships, fund sponsors and other taxpayers that use limited partnerships for investment purposes should contact their advisors and examine their structures in order to determine whether they are caught by the Draft Legislation, and if so, what the impact of the Draft Legislation will be.

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