Investments by Canadians in Private Equity Funds: Primary and Secondary Transactions

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Abstract

Private equity funds are becoming more prevalent in Canada and internationally. The authors consider an investment in a private equity fund, whether established in Canada or abroad, from the perspective of a Canadian investor, and they consider protections that Canadian investors might seek from a Canadian tax perspective. The authors also address Canadian tax considerations that may apply on the sale of a previously issued unit of a fund.

Keywords Effectively connected; FAPI; FATCA; FIRPTA; limited partnerships; SIFT entities; taxable Canadian property; withholding taxes; foreign investment.

Introduction

A number of papers have addressed the considerations that managers take into account in structuring private equity funds.[1] In this paper, we address the tax issues from the perspective of an investor in the initial capital raise of a fund (herein referred to as a "primary transaction") and from the perspective of the seller and buyer of a previously issued interest in a fund (herein referred to as a "secondary transaction"). Although private equity funds may follow a number of investment strategies, including venture capital, growth capital, distressed investments, or mezzanine capital, this paper addresses buyout funds that acquire material or controlling interests in companies, make changes to improve profitability, and sell them or take them public for a profit. Such companies are often referred to as "portfolio companies" in fund documentation.

In a primary transaction, the investor is generally making an investment into a blind pool of capital on the basis of the reputation of the manager and the performance of funds previously managed by the manager. A careful review of

the constating documents of the fund and offering memorandum is necessary in order to identify tax and commercial risks, some of which may be addressed by requesting changes to the constating documents or by seeking additional protections in a side letter with the manager. Of course, the receptiveness of the manager to requested changes varies in direct proportion to the size of the proposed investment and the scarcity of other investors. Larger investors may also seek "most favoured nation" protection. In general, an investor that secures a most favoured nation clause will be automatically entitled to the benefit of additional protections that other investors making the same or a smaller investment are able to negotiate, or will be entitled to opt into such protections.

It is also common for managers to address the tax preferences of classes of investors by establishing "parallel funds" when forming a fund. For example, non-US investors may not want to invest in a limited partnership that would derive income or gain that is considered effectively connected with the conduct of a US trade or business pursuant to section 864 of the Code;[2] the investment would expose such investors to US taxation and the requirement to file US tax returns. The manager might set up a parallel partnership for such non-US investors and agree to try to ensure that the parallel partnership makes each such investment through "blocker entities" (that is, entities that are regarded as corporations for US federal income tax purposes). The two partnerships will collectively constitute the "fund," and, to the extent possible, the economics will be integrated.

In a secondary transaction, the fund will likely have made some investments with capital from a primary transaction. In some cases, the fund will have fully invested all of its committed capital and may have already sold a number of investments. If the fund has not fully invested its committed capital and the fund's investment period has not ended, the buyer of an interest in the fund will generally assume the seller's remaining capital commitment obligations. The buyer of an interest also needs to perform a due-diligence review of the investments that the fund currently holds, along with their tax attributes, and, if the fund is not fully invested, consider what additional investments could be acquired. The manager may provide information to the buyer but will generally not provide representations and warranties. The manager generally does not negotiate side letters in secondary transactions, and the seller will not be entitled to assign to the buyer the benefit of any side letter that the seller negotiated. A buyer may want to purchase the interest because it can be acquired at a discount, or to be considered as a potential investor in the manager's next fund. A seller may be motivated to sell its investment in a fund for a number of reasons, including a change in the seller's investment strategy, a change in the seller's investment manager, a sale of the seller's portfolio of funds that includes the particular fund, or a need for cash. In such cases, the seller generally seeks a prompt liquidation of its investment (perhaps at a discount) rather than waiting until the fund is terminated in order to realize on its remaining investment. The manager's consent to a transfer is usually required. In deciding whether to consent to transfer, the

manager will want to ensure that the transaction does not adversely affect the fund's tax status or other status, or the status of any other investor in the fund.

General partner-led (GP-led) secondary transactions of funds structured as partnerships are also becoming more common, and they include GP-led tender offers or restructurings. In a GP-led tender offer, each of the limited partners sells some or all of its limited partnership interest to a buyer. In a GP-led restructuring, the general partner typically establishes a special purpose vehicle (SPV) managed by the partner. The general partner enters into an agreement to sell some or all of the fund assets to the SPV. Limited partners can choose to sell their interests and receive a pro rata portion of the cash purchase price or, if they want to maintain an interest in such fund assets, to transfer an appropriate portion of their limited partnership interest to the SPV in exchange for an interest in the SPV.

In what follows, with the foregoing as background, we consider tax issues arising in primary and secondary transactions.

Primary Transactions

Structure of the Fund

The first category of issues relates to the structure of the fund and the proposed investment strategy.

Entity Characterization Issues

In Canada, although a fund can be established as a corporation, trust, partnership, or co-ownership arrangement, it is usually structured as a limited partnership, and the provisions of the Act[3] relating to partnerships apply.

A fund established in a foreign jurisdiction must, for Canadian tax purposes, be characterized as a corporation, partnership, trust, or co-ownership arrangement. The tax treatment of the fund in the foreign jurisdiction is not relevant for the purposes of entity characterization. Instead, Canada applies a comparability test.[4] In general, a two-step process is followed. First, the characteristics of the fund under foreign private law must be determined. The most important attributes are legal personality and limited liability, but other factors of less significance are also considered, such as management, perpetual life, and free transferability of interests. Second, those identified characteristics are compared with the principal types of business organizations under Canadian private law (corporations, partnerships, trusts, or co-ownership arrangements). The Canada Revenue Agency (CRA) has stated that while all characteristics of the fund are to be considered, the most crucial elements are "the nature of the relationship between the various parties and the rights and obligations of the parties under the applicable laws and agreements."[5]

Funds established in the United States are usually limited partnerships that are treated as partnerships for Canadian tax purposes. We (the authors of this

paper) have yet to confront the CRA's administrative practice with respect to limited liability partnerships and limited liability limited partnerships[6] in the context of a private equity fund.

Many funds established in Europe are characterized as co-ownership arrangements ("co-ownerships") for Canadian tax purposes. From a Canadian tax perspective, co-ownerships pose unique issues that are generally manageable in the context of a private equity fund, since units of the fund will be issued only occasionally, and the fund will have a small number of investments. As a co-owner, an investor owns a proportionate interest in each property owned by the fund. The investor is considered to derive its share of income and gains from the fund as the fund earns income or disposes of an investment. However, the admission of a new investor on a subsequent closing results in the reduction of an existing investor's proportionate interest in each property owned by the fund. That is, the investor has disposed of an interest in each such property.[7] Fortunately, because there are generally few closings after the initial closing and the fund is likely not to have made many investments at that time, the calculation is manageable if the manager has agreed to provide the investor with the necessary information. In addition, the investments are likely not to have appreciated significantly, because they will not have been held for a long time and therefore the manager will not have executed its business strategy with respect to them.

Other European funds are structured as limited partnerships, and it is necessary to consider whether they would be regarded as partnerships or corporations for Canadian tax purposes, as discussed above.

Although the tax treatment of the fund in the foreign jurisdiction is not relevant in characterizing the fund for Canadian tax purposes, that treatment is relevant in determining whether the fund is entitled to treaty benefits in its own right. For example, a Spanish "Fondos de Capital-Riesgo" (FCR) is a pool of assets divided into units, without legal personality, managed by a management company—a fund that (we would submit) should be regarded as a co-ownership for Canadian tax purposes. However, an FCR is treated as a corporation for Spanish tax purposes, although it pays little tax in practice, because of exemptions. Consequently, it should be regarded as a "person" for the purposes of tax treaties that adopt the definitions of "person" (which includes "a company and any other body of persons") and "company" (which includes "any entity that is treated as a body corporate for tax purposes") in the Organisation for Economic Co-operation and Development (OECD) model tax convention.[8]

Nature of Return To Be Earned

The fund's investment strategy should be reviewed to determine the tax character of expected returns. Many funds contemplate equity investments in portfolio companies, with the expectation that the exit transaction will give rise to a capital gain.

Investments of other funds may include debt of portfolio companies that may be convertible into equity. The expectation is that a substantial portion of the return will be interest income that will be fully taxable to taxable investors. In the case of a Canadian fund or a fund requiring a computation of income in accordance with the Act, the interest accrual rules will generally apply.[9] If a debt instrument held by the fund is a prescribed debt obligation, interest will be deemed to accrue in the prescribed manner.[10]

If the investment strategy of a fund contemplates equity investments in portfolio companies, the fund may retain the flexibility to make some of the investment in a portfolio company in the form of debt in order to improve the tax efficiency of the portfolio company.

Foreign Affiliate Issues

If the fund is a non-resident corporation, the investor must consider whether the fund would be a foreign affiliate (FA)[11] and a controlled foreign affiliate (CFA) of the investor.[12] If it would be a CFA, the investor must consider whether the fund itself will generate "foreign accrual property income"[13] (FAPI) and whether portfolio companies controlled by the fund will have FAPI that may give rise to an income inclusion under subsection 91(1). If the fund would be a CFA of the investor, the investor should be able to require the manager to provide it with the information necessary to file its Canadian tax returns and to comply with the requirement in subsection 233.4(4) that a T1134 information return[14] be filed in respect of its interest.

If the fund is a co-ownership, the investor must consider whether its co-ownership interest (together with the combined interest of related persons) in an investment by the fund in a non-resident portfolio company would be such that the portfolio company could be an FA or CFA of the investor. Generally, this should be a concern only if the investor, together with related persons, will own 10 percent or more of the fund.

If the fund is a partnership, the investor must consider whether the partnership will make an investment in a corporation that would be a CFA of the partnership. If so, the fund must apply subsection 91(1) in computing its income. If the manager has specifically targeted Canadian investors, the fund should be required to calculate its income for the purposes of the Act, including any FAPI inclusion under subsection 91(1), and to allocate that income among the partners so that Canadian partners can include the appropriate amount in their income. In other cases, the fund will not make that calculation.

In general, unless taxable Canadian-resident investors are entitled to more than 10 percent of the income or loss of a partnership, the partnership will not be a "specified Canadian entity" as defined in subsection 233.4(1), and the partnership will not be a "reporting entity" required to file form T1134.[15] If taxable Canadian-resident investors are entitled to more than 10 percent of the income

or loss of the partnership, the partnership will be a reporting entity if a portfolio company of the partnership is an FA of the partnership.

If the fund is a partnership and the investor, together with related persons, will have a significant interest (at least 10 percent) in the partnership, section 93.1 may be relevant in determining whether the investor must file form T1134. Subsection 93.1(1) provides that, for the purpose of determining whether a non-resident corporation is an FA of a corporation resident in Canada for the purposes of provisions specified in subsection 93.1(1.1), including section 233.4, each member of a partnership is deemed to own that proportion of shares of a corporation that are owned by the partnership as is equal to the proportion that the fair market value (FMV) of the member's interest in the partnership is of the FMV of all members' interests in the partnership. The provision applies iteratively in the case of tiered partnership structures.

Offshore Investment Fund Property

Subsection 94.1(1) of the Act requires a notional amount to be included in income if a taxpayer holds an interest in an "offshore investment fund property" (OIFP). An OIFP is a share of the capital stock of, an interest in, or a debt of, a non-resident entity (other than a CFA of the taxpayer) or an interest in or a right or option to acquire such a share, interest, or debt if two conditions are satisfied.

First, the relevant share, interest, or debt of the non-resident entity must reasonably be considered to derive its value, directly or indirectly, primarily from "portfolio investments" of that or any other non-resident entity in certain properties, including shares, indebtedness, interests in one or more corporations, trusts, partnerships, organizations, funds or entities, and real estate, or any combination thereof.

Second, it must be reasonable to conclude, having regard to all of the circumstances, that one of the main reasons for the taxpayer acquiring, holding, or having the relevant share, interest, or debt was to derive a benefit from portfolio investments in such assets in such a manner that the taxes, if any, on the income, profits, and gains from such assets for any particular year are significantly less than the tax that would have been applicable under part I of the Act if the income, profits, and gains had been earned directly by the taxpayer. In making this determination, the following must be considered:

1) the nature, organization, and operation of any non-resident entity and the form of, and the terms and conditions governing, the taxpayer's interest in, or connection with, any non-resident entity;
2) the extent to which any income, profits, and gains that may reasonably be considered to be earned or accrued, whether directly or indirectly, for the benefit of any non-resident entity are subject to an income or profits tax that is significantly less than the income tax that would be applicable to such income, profits, and gains if they were earned directly by the taxpayer; and

3) the extent to which the income, profits, and gains of any non-resident entity for any fiscal period are distributed in that fiscal period or the one immediately following.[16]

Although entities in which a private equity fund invests are described as "portfolio" companies, subsection 94.1(1) should not generally apply to a typical buyout fund that is not fiscally transparent (for example, a non-resident corporation), since such funds seek to take significant or controlling interests that should not be regarded as "portfolio investments." In *Gerbro Holdings*,[17] the Tax Court held that the ordinary commercial meaning of "portfolio investment," in the international investment context, is an investment in which the investor (non-resident entity) is not able to exercise significant control or influence over the property invested in.

How Is Income Allocated?

If the fund is a corporation, the investor must include in income dividends that are received or deemed to be received.[18] If the fund is a non-resident corporation and an FA of the investor, an amount is deemed to be a dividend received on a share of the corporation if it is the share's portion of a pro rata distribution made by the corporation in respect of all of the shares of that class except a distribution made (1) in the course of a liquidation and dissolution of the corporation; (2) on a redemption, acquisition, or cancellation of the share by the corporation; or (3) on a qualifying return of capital in respect of the share.[19] If the fund is not an FA of the investor, the character of a distribution by the fund as a dividend or a reduction of capital should be determined in accordance with the corporate law applicable to the fund.

If the fund is a partnership, subsection 96(1) provides that the partnership's income is to be determined as if the partnership were a separate person resident in Canada, the taxation year of which is its fiscal period. The income (or loss) of the partnership is to be allocated to the partners in accordance with the partnership agreement, and, in general, each partner includes in its income, for the taxation year in which the fiscal period ends, its share of the partnership's income or, subject to the at-risk rules,[20] deducts its share of the partnership's loss. The income allocation provisions generally provide that allocations of income to partners follow distributions by the partnership to partners. A provision often exists to the effect that it is intended that, over the term of the partnership, allocations for tax purposes should reflect the economic returns to the partners.

The at-risk rules limit the deduction by a "limited partner"[21] of its share of certain losses of the partnership. In general, if the investor is a limited partner, its share of the amount of any loss of the partnership for the fiscal year from a business (other than a farming business) or from property in excess of the investor's at-risk amount at the end of the fiscal period is not deductible in the year and will be treated as a limited partnership loss. The at-risk rules do not limit the deduction

by a limited partner of its share of the partnership's allowable capital losses. Furthermore, these rules should be of limited practical concern to an investor on a primary transaction, given the significant cost of a partnership interest relative to the deductible expenses expected to be incurred by the partnership.

How Will Tax Reporting Be Provided to Investors? Will It Be Canadian?

If the fund is a corporation, tax reporting should be straightforward. Unless the fund is a CFA, the investor should ordinarily be able to derive on its own the information it needs to make its Canadian tax filings (generally, dividends received and capital gains realized on the disposition of shares, or reductions of capital that result in a negative adjusted cost base [ACB] of the shares).

Funds formed by non-Canadian managers typically provide tax reporting pursuant to the Code or to the laws of the fund's jurisdiction of formation, and they rarely contemplate the specific requirements of investors resident in other countries, such as Canada. A Canadian investor may seek a covenant from the manager to provide either (1) such information as may reasonably be considered necessary for the investor to file its Canadian tax returns or (2) such information as may reasonably be requested by the Canadian investor to allow it to file its Canadian tax returns. If the manager agrees, the Canadian investor will likely be required to pay any incremental costs of providing the information.

If the manager does not agree to provide additional information, the Canadian investor must interpret the tax reporting received and reconcile the available information with Canadian tax rules. For example, a US-domiciled fund typically provides to each investor a schedule K-1,[22] prepared in accordance with the Code and within the time required by the Code. A Canadian investor must reconcile the information on the schedule K-1 with Canadian rules. Furthermore, the schedule K-1 for a taxation year may not be available when the Canadian investor is required to file its tax returns for that taxation year. In this case, the Canadian investor may be required to estimate its allocation of income from the fund on the basis of other information in order to file its return as required and request an adjustment when the schedule K-1 becomes available.

Availability of Tax Distributions if Investor Is Expected To Be Liable for Tax?

An investor contemplating a commitment to a fund structured as a partnership will want to ensure that allocations of income from the partnership match as closely as possible distributions received from the partnership. Mismatches in timing between the allocation of income and distributions may result in a "dry income" situation where the investor is required to pay income tax on an amount of income allocated without having received the cash distribution related to that allocation. If this is a concern, the investor may consider requesting that the

partnership make tax distributions to the investor. A tax distribution is generally treated as an advance against future distributions and is computed on the basis of an agreed-on formula such as the estimated taxable income multiplied by the highest marginal tax rate applicable to an individual in the individual's jurisdiction of residence.

Manager Compensation Considerations

The manner in which the fund compensates its manager should be considered, because the tax results to the fund and the fund's investors may differ depending on the method of compensation. In Canada, a manager is generally compensated in one of two ways: a management fee or a general partner distribution (GPD). The fund pays the same amount to the manager under both methods, but the income tax treatment is different. In a management fee arrangement, the management fee earned by the manager is business income and is taxed at regular business rates. The management fee is treated as a deductible expense by the fund. In a GPD arrangement, the manager is also the general partner of the fund partnership and receives a priority distribution of the amount from the fund. The GPD is treated as a distribution by the partnership to the general partner such that the general partner will be allocated an amount of income of the fund, if any, since income is generally allocated in accordance with distributions. The nature of this income will depend on the type of income earned by the fund during the year. Under both methods, sales tax—that is, goods and services tax/harmonized sales tax (GST/HST)—applies to the amount earned by the manager, and no input tax credit or refund will be available to the fund.[23]

Carried interest, or "carry," is the share of profit earned by the manager or the manager's senior investment professionals on successful exits of investments made by the fund. The manner in which the amount of carry is calculated and the time at which it is earned can differ among managers and even among funds managed by the same manager. It is common for investors to be entitled to a preferred return on their invested capital before any carry can be earned.

In a limited partnership, the carry will be allocated to the general partner or to a carried interest partner (each a "carry partner") as a share of the capital gain derived on the disposition of the investment. The carry partner may not be entitled to receive the carry until a later time, in which case the partnership agreement generally permits a tax distribution on account of the allocated carry sufficient for the carry partner (or for its members, if it is a partnership or other transparent entity) to pay taxes on account of the allocation of the carry. Carry is also regularly subjected to a "clawback mechanism" (discussed below), agreed to in the fund documents, that protects the investors of a fund if the carry partner is allocated too much carry.

Clawbacks

"Clawback" generally refers to a partnership's right to reclaim part of a carry partner's carry if subsequent losses mean that the carry partner received excess distributions. The reclaimed carry is distributed to the limited partners. This situation may arise if carry is calculated (and distributions are made) as each investment is realized, because the overall entitlement to carry is determined on the termination of the fund. For example, if a fund successfully exits some investments early in its term, it may pay carry to the carry partner. If the fund suffers losses on the rest of its portfolio investments, the clawback mechanism may apply and require the carry partner to pay back to the fund some or all of the carry previously distributed to it for the benefit of the fund's investors.

If there has been an excess distribution, the clawback amount will typically be net of taxes that the carry partner (or its members) was required to pay on the excess distribution. In some cases, if the carry partner (or its members) would obtain a tax benefit as a result of paying the clawback, the clawback is correspondingly increased.

Will Blockers/Alternative Investment Vehicles Be Used?

Fund agreements often contain a provision requiring certain portfolio investments to be made through a blocker entity. This provision is typically found in a fund (or parallel fund) structured as a limited partnership targeted at US tax-exempt entities or non-US investors where the fund may make investments in portfolio companies that are expected to generate "unrelated business taxable income" (UBTI)[24] or "effectively connected income" (ECI).[25]

In such cases, the fund will establish a blocker entity that is regarded as a corporation for US federal income tax purposes, and the fund will invest in the blocker entity. The blocker entity then makes the investment in the portfolio company. Structuring will be required to minimize the tax liability of the blocker entity. From a Canadian investor's perspective, the blocker entity, if it is a non-resident corporation, will likely be a CFA of the fund. In order to improve tax results to investors, fund agreements or side letters may require the fund to use its best efforts, on a liquidity event, to dispose of the blocker entity's securities rather than the shares of the portfolio company held by the blocker.

Fund agreements may also contain a provision permitting, or in some circumstances requiring, the general partner to establish an "alternative investment vehicle" (AIV) to make a portfolio investment instead of the main fund. Again, a fund established as a partnership might contemplate an investment in a portfolio company that is expected to generate UBTI or ECI. While tax-exempt entities or non-US investors may want to invest in the portfolio company through a "blocker" structure, investors indifferent to UBTI or ECI prefer that the fund make the investment directly. In this case, a separate limited partnership could be established as an AIV to make the investment. The general partner of the fund

would act as the general partner of the AIV. A blocker entity would also be formed. Each investor in the fund could then choose whether it wants to invest in the AIV directly or through the blocker entity. If an investor chooses to invest through the blocker, the relevant portion of the investor's commitment to the fund is drawn down and invested in the blocker, which in turn invests in the AIV. If the investor chooses to invest in the AIV directly, the relevant portion of the investor's commitment to the fund is drawn down and invested by the fund in the AIV. The AIV then acquires the interest in the portfolio company.

Although establishing and maintaining an AIV structure may involve significant additional costs, it may be preferred to the fund that uses a blocker entity. The blocker entity may be taxable, which reduces the return to investors indifferent to UBTI or ECI. In addition, from the perspective of the general or "carried interest" partner, carry will be payable only from after-tax distributions made by the blocker. In the AIV structure, investors that are indifferent to UBTI or ECI can invest directly in the AIV that is a flowthrough. In addition, carry can be paid by the AIV to the general partner before income flows through the blocker entity.

An issue with respect to AIVs is the degree to which the economic provisions of the AIV and the main fund are coordinated in such a way that the amount of distributions and carry are the same, on an aggregate basis, as if all of the investments were made by the main fund. From a commercial perspective, the economic provisions must be coordinated; otherwise, carry could be payable by the AIV if its investment is profitable, even though no carry should be payable, since the main fund and the AIV collectively operate at a loss or fail to generate the preferred return. Despite the potential risk that tax authorities may assert that only a single partnership exists, commercial considerations usually prevail. If an AIV structure is used and the investor transfers an interest in the main fund, the investor must also transfer an interest in the blocker or AIV, as applicable, which adds complexity.

Nature of Commitment: Capital Versus Debt

Committed capital is the amount that an investor agrees to invest in the fund. With private equity funds, unlike other types of funds (such as mutual funds), investors do not pay all of the committed capital on closing as a lump sum but, instead, agree to make payments over a specified number of years after the fund is formed. The obligation to make payments usually expires at a particular time. Managers may rely on committed capital to cover investments, fees, expenses of the fund, or a combination of these items.

In our experience, investments in most funds are structured as equity. Some funds, however (generally corporations), consider structuring investments as a combination of debt and equity or, in some cases, by way of debt only. When all or part of an investment is by way of debt, the investor must consider the effect of the interest accrual rules and whether the debt is a prescribed debt obligation.

Restrictions on Investors

Funds may impose limitations on the nature of investors permitted to invest in the fund. In the case of Canadian funds, restrictions on the ability of non-residents and financial institutions to invest are common. A Canadian manager may want a fund structured as a partnership to be a "Canadian partnership" at all times. A "Canadian partnership" is a partnership all of the members of which are resident in Canada at the time in respect of which the expression is relevant.[26] In such cases, the current practice is to require a representation and warranty from the investor that it is not a "non-resident" of Canada for the purposes of the Act or—if it is a partnership—that it is a "Canadian partnership" within the meaning of the Act.

Canadian partnership status is significant if the fund anticipates receiving dividend income from Canadian investments or investing in taxable Canadian property, or both. Paragraph 212(13.1)(b) provides that where a person resident in Canada pays or credits an amount to a partnership (other than a Canadian partnership), the partnership shall be deemed, in respect of that payment, to be a non-resident person. Consequently, amounts paid or credited by a person resident in Canada to a partnership that is not a Canadian partnership may be subject to withholding tax under part XIII, subject to the application of an applicable tax treaty.

Canadian partnership status is also relevant if the fund is expected to make investments in portfolio companies that would be taxable Canadian property when disposed of by the partnership. A non-resident is liable to tax on taxable capital gains derived from the disposition of taxable Canadian property,[27] including its share of such capital gains realized by a partnership of which it is a member. Under section 116, a non-resident that disposes of certain taxable Canadian property must notify the CRA of the disposition either before the disposition or within 10 days thereafter. In the case of a partnership's disposition of taxable Canadian property, the policy of the CRA is to accept one notification of disposition filed on behalf of all partners. However, the CRA must be provided with a complete listing of the non-resident partners that are disposing of the property, along with their Canadian and foreign addresses. In the case of a partnership in a multi-tier partnership, the CRA requires disclosure of the indirect partners. Generally, each partner is required to file a tax return, and, accordingly, each partner's final tax liability will be determined when the tax returns are filed and assessed.[28] If the partnership is a Canadian partnership, no partner can be a non-resident, and, as a result, the manager need not be concerned about investments in taxable Canadian property.

Canadian partnership status is also relevant for the purposes of certain partnership reorganization rules. Certain reorganizations can be implemented by Canadian partnerships on a tax-deferred basis.

A partnership, corporation, or trust that is a "financial institution," as defined in subsection 142.2(1), is required to treat gains and losses on "mark-to-market property" on income account. In addition, if a taxpayer that is a financial institution in a taxation year holds, at the end of the year, a mark-to-market property

for the year, the taxpayer is deemed to have disposed of the property immediately before the end of the year for proceeds equal to its then FMV and to have reacquired the property at the end of the year at a cost equal to those proceeds. Mark-to-market property includes property, other than excluded property, that is a share, a specified debt obligation, or a tracking property that is fair value property. In the private equity context, a share of a portfolio company will be a mark-to-market property unless it is an "excluded property." A share would generally be an excluded property if, at any time in the relevant taxation year, the fund has a significant interest in the corporation. The fund would have a significant interest in a corporation at any time if the fund is related to the corporation at that time (otherwise than because of a right referred to in paragraph 251(5)(b)) or if the fund holds at that time shares of the corporation that (1) give the fund 10 percent or more of the votes that could be cast under all circumstances at an annual meeting of the corporation's shareholders, and (2) have an FMV of 10 percent or more of the FMV of all of the issued shares of the corporation.[29]

Because it is possible that a fund may acquire or hold shares in a portfolio company that are not excluded property, a manager will want to ensure that the fund is not a financial institution. If the fund is a corporation, it will generally be a financial institution if it is controlled by one or more persons or partnerships that are financial institutions. If the fund is a trust or partnership, it will be a financial institution if more than 50 percent of the FMV of all interests in the trust or partnership are held at that time by one or more financial institutions.

Managers generally follow one of two approaches. Some managers require each investor to represent and warrant that it is not a financial institution and covenant not to change its status. The manager will not admit to the fund any investor that cannot give such a representation, warranty, and covenant. Alternatively, a manager will require investors to disclose whether they are financial institutions and may admit financial institutions, taking care to leave a comfortable cushion in applying the 50 percent test.

SIFT Issues

A trust will generally be a "specified investment flowthrough" (SIFT) trust for a taxation year if, at any time during the taxation year, (1) it is resident in Canada, (2) investments in it are listed or traded on a stock exchange or other public market, and (3) it holds one or more non-portfolio properties.[30] A partnership will generally be a SIFT partnership for a taxation year if, at any time in the taxation year, (1) it is a Canadian-resident partnership, (2) investments in it are listed or traded on a stock exchange or other public market, and (3) it holds one or more non-portfolio properties.[31] Unless the investment focus of the fund is exclusively on portfolio companies established outside Canada and having no Canadian operations, it is prudent to assume that the fund may hold one or more non-portfolio properties at some point.[32]

A SIFT trust or SIFT partnership is generally liable to tax at corporate rates on its income (other than taxable dividends) from non-portfolio property and on

taxable capital gains from the disposition of such property.[33] Consequently, it will be critical that "investments" in the trust or partnership are not listed or traded on a stock exchange or other public market that includes any trading system or other organized facility on which securities that are qualified for public distribution are listed or traded (other than a facility, such as FundServ, operated solely to carry out the issuance of a security or its redemption, acquisition, or cancellation by its issuer).[34]

An "investment" in a trust or partnership means a property that is a security of the trust or partnership, or a right that may reasonably be considered to replicate a return on, or the value of, a security of the trust or partnership.[35] A "security" of a trust or partnership includes a liability of the trust or partnership and a capital or income interest in a trust or interest as a member of a partnership.[36] Ordinarily, liabilities of a fund or interests in the fund are not listed or traded on a stock exchange, and investors may be required to covenant that they will not trade their interest in the fund on a public market.

The second branch of the definition of "investment" may be problematic. It contemplates a right that may reasonably be considered to replicate a return on, or the value of, a security of the trust or partnership. It requires one to look above the investor. If the investor were an SPV formed to make the investment in the fund, one would have to determine whether interests in the SPV were listed or traded on a stock exchange or other public market. Where investments may be acquired that would be non-portfolio properties, some managers require each investor to represent and warrant that the admission of the investor to the fund would not cause the fund to become a SIFT trust or SIFT partnership, as the case may be (on the assumption that the fund held non-portfolio property).

The rules applicable to SIFT partnerships have an analogue in section 7704 of the Code pursuant to which certain "publicly traded partnerships" are treated as corporations. A publicly traded partnership is a partnership the interests of which are either traded on an established securities market or readily tradeable on a secondary market or the substantial equivalent. It is beyond the scope of this paper to address these rules in detail. However, it is customary for US managers of funds not to allow transfers of interests in a fund if the transfer could cause the fund to become a publicly traded partnership.

Tax Shelter Issues

It is unlikely that an interest in a fund will be a "tax shelter" because, in general, no statements or representations are made, in marketing an interest in the fund, that relate to the amount of deductions an investor could claim in computing income, taxable income, or tax payable.[37] No statements or representations are made regarding the deductibility of interest on money borrowed to acquire an interest in the fund. Consequently, market practice is that tax shelter identification numbers are not obtained in relation to private equity funds.

Even if it is not a "tax shelter," an investor's interest in a fund structured as a partnership could be a "tax shelter investment" if an interest in the investor

is a "tax shelter investment" and the investor's interest in the fund would be a "tax shelter," making the modifications to that definition as contemplated by clause 143.2(1)(b)(i)(B) of the definition of "tax shelter investment."[38] An investor's interest in a fund structured as a partnership could also be a "tax shelter investment" as contemplated by subparagraph (b)(iii) of the definition, but that subparagraph takes into account investments made by the fund, directly or indirectly, in another partnership that is not within the control of the investor.

However, if any interest in a partnership is a tax shelter investment, then every interest in the partnership will be a "tax shelter investment" because of subparagraph (b)(ii) of the term's definition. Consequently, it is customary for an investor to be required to represent that no interest in the investor is a tax shelter investment.

Foreign Account Tax Compliance Act and Common Reporting Standard Compliance Remedies

Like Canada, other countries have enacted rules requiring financial institutions, as defined under the relevant domestic legislation adopting the Foreign Account Tax Compliance Act (FATCA) or the Common Reporting Standard (CRS), to identify their non-resident account holders so that this information can be exchanged between tax authorities.

It is market practice for investors who make a commitment to a private equity fund to provide FATCA and CRS self-certification forms as part of the subscription and investor onboarding process. Since penalties may be assessed against a fund that fails to collect and report required information to tax authorities, the interests of the fund and the investors are aligned when it comes to ensuring that the fund is fully compliant with its FATCA and CRS obligations.

Investors regularly request that the manager agree to allocate any penalties or interest assessed against the fund because of a particular investor's non-compliance to that non-compliant investor. On the other hand, managers typically include language in the fund agreements requiring every investor to provide its FATCA and CRS information before being admitted to the fund and to undertake to update the manager when the forms expire or if any of the information contained in the forms changes. According to our recent experience, some managers have gone so far as to provide in the fund documents for the forced redemption of an investor's units at a materially discounted redemption price if FATCA and CRS information is not provided or updated. Although this may be an extreme measure, investors should be aware of it when reviewing fund documents.

Tax ID Numbers/Certificates of Residence

When subscribing to a fund, an investor is typically required to provide certain information to the manager, including the details of the investor's tax residence status and the investor's ability to access benefits available in applicable tax treaties.

Funds formed in certain jurisdictions may also require the investor to obtain a certificate of residence, stamped or signed by the tax authority in the investor's home jurisdiction, to provide evidence that the investor is resident in that jurisdiction. Depending on the jurisdiction, obtaining this certificate of residence may be difficult or time consuming, which may pose an issue if the manager requires that the certificate be delivered before the investor is admitted to the fund. For example, the CRA is not able to certify the residence of a partnership because partnerships are not considered residents. Although the CRA may be able to certify that a partnership is a "Canadian partnership,"[39] a representative authorized to act on behalf of each partner of the partnership must make this request. The CRA expects that it will process a request for a certificate of residence in approximately eight to ten weeks.[40]

Bipartisan Budget Act (BBA) Audit Rules

The US BBA of 2015[41] introduced new audit rules for partnerships with tax years beginning after December 31, 2017.[42] Under these rules, an adjustment to a partnership-related item is to be determined, and any related tax is to be assessed, at the partnership level except as otherwise provided.

In general, under the default rule of the BBA audit regime, the Internal Revenue Service (IRS) examines all partnership-related items for the partnership's tax year under audit. If any partnership adjustments result in an imputed underpayment, the IRS will assess and collect it from the partnership in the year in which it sends the notice of final partnership adjustment. In determining the amounts assessed, the highest applicable tax rate in effect for the tax year under review is used.

The imputed underpayment generally does not take into account the tax attributes (for example, tax-exempt status) of the partnership's direct or indirect partners that would otherwise reduce the imputed underpayment such that the imputed underpayment would be too high. Second, those persons who are partners in the adjustment year will bear the burden of an imputed underpayment even if they were not partners for the tax year under review; former partners generally will not bear any economic impact.

Procedures are available to mitigate these issues. One procedure is to request permitted modifications of an imputed underpayment (for example, by taking into account the tax-exempt status of a partner or an entitlement to treaty benefits). Another procedure is to make an election under which the partnership commits to providing all of those persons who were partners in the tax year under review with statements reflecting their shares of the partnership adjustments and other required information. The partners must take into account their shares of partnership adjustments and adjust their own previous filings.

Under the BBA audit rules, a partnership is required to appoint an individual, referred to as the "partnership representative," who has the authority to represent the partnership during the audit and negotiate with the IRS. The partnership

representative has the authority to take the mitigation steps described above. The partners of the partnership do not have a statutory right to participate in the audit. The partnership representative is usually specified in the limited partnership agreement of the fund. Investors that are tax-exempt or entitled to treaty benefits will want the partnership to agree to make certain elections available to the partnership if there is an audit of the partnership.

The BBA audit rules are complex, and a full discussion of them is beyond the scope of this paper.

Liquidity Before Maturity: Restrictions on Transfer

Private equity funds typically do not allow investors to redeem their investments before the end of the term. Consequently, liquidity before the end of the term will be by way of a sale of the investor's interest in the fund.

The manager or general partner must consent to a transfer. A transferee will generally be required to give substantially the same representations, warranties, and covenants as an original investor and to assume liability for any undrawn commitment of the transferor. In order to ensure that the trade does not cause the partnership to become a SIFT partnership or cause the publicly traded partnership rules in the Code to apply, the manager or general partner will also seek assurance that the trade has not been effected through a public market.

Confidentiality Provisions

Investors should carefully review the confidentiality provisions in the fund documents. Some are drafted so broadly that they could be interpreted as precluding disclosure by an investor of information necessary for it (1) to file its tax returns or (2) where the investor is a fund, to provide information to allow its own investors to file their tax returns. In such a case, the investor should request that the fund agreement be amended to provide appropriate carve-outs (since other investors likely have similar concerns) or that consent to disclosure be provided in a side letter.

Considerations Relating to Proposed Investments by the Fund

Potential Foreign Filings, Foreign Taxes, and Steps To Avoid

An investor strongly prefers that a fund and its manager ensure that the investor will not be required, because of its investment in the fund, to file an income tax return or pay tax, other than withholding taxes, in a jurisdiction other than the investor's home jurisdiction. An investor is not likely to be familiar with the tax law of another country and will not want to undertake the obligation and expense of engaging a tax adviser to submit proper filings in an unfamiliar jurisdiction.

Investors often ask for assurance that the manager will structure the fund's investments such that the investor is not required to file a return or pay tax other than in the investor's home jurisdiction. In response, the fund's constating documents or a side letter will normally provide that the fund will use commercially reasonable efforts (1) to ensure that the investor is not exposed to tax-filing or payment obligations outside the investor's home jurisdiction, other than withholding taxes; (2) to notify the investor if a tax-filing obligation arises as a consequence of the fund's investing activities; and (3) to provide any information required by the investor to make proper filings and payments to a tax authority outside the investor's home jurisdiction. Managers regularly provide comfort on this point by explaining to investors how internal and external tax advisers are involved in the managers' due diligence and execution processes with respect to investment, and by confirming the managers' familiarity with cross-border investing.

Real Property Exposure

If a fund invests in real or immovable property in a jurisdiction, investors who are resident outside that jurisdiction may become subject to withholding tax and potential tax-filing obligations. Like Canada, other countries have adopted withholding regimes for income and gains derived from real or immovable property, including the US Foreign Investment in Real Property Tax Act (FIRPTA) of 1980 and Australia's taxable Australian property (TAP) regime. A direct investment in real or immovable property is generally rare in a private equity fund, but these rules are regularly considered in the context of infrastructure funds because of the nature of these funds' investments.

Although most investors concede that withholding tax may apply when a fund disposes of real or immovable property, investors that are able to take advantage of specific exemptions[43] should alert the manager of their special status and attempt to obtain assurances from the manager that the manager will attempt to structure such investments to allow the investor to take advantage of that status. Certain funds may also pool all such investors into their own parallel vehicle.

ECI/UBTI Exposure

As discussed above, non-US investors and tax-exempt investors are generally adverse to portfolio investments that generate ECI or UBTI because such investments may trigger US income tax-filing obligations and tax liabilities as if the investor earned this type of income directly. The manager must consider this when structuring its portfolio investments. A blocker entity or AIV can be used to manage this exposure.

Hybrid and Reverse Hybrid Issues (Canada-US Tax Treaty)

Canadian investors investing in funds that make US investments will expect that such US investments are structured so that a Canadian investor is able to take

advantage of the benefits of the Canada-US tax treaty.[44] The anti-hybrid rules[45] may deny treaty benefits on amounts of income derived from hybrid entities by residents of either country. Lack of access to treaty benefits could result in leakage for the investor, especially a tax-exempt investor such as a pension plan or charitable foundation. To ensure that the manager is attentive to this issue, investors typically request language in the fund agreements requiring the manager to use entities that do not give rise to hybrid or reverse hybrid issues for the investor.

Post-Investment Issues

Monitoring Withholding Taxes

An investor will want the manager to minimize any withholding taxes on distributions returned from portfolio investments if the investor is not able to claim a full foreign tax credit in respect of such withholding taxes. This is especially important if the investor is a tax-exempt investor such as a pension plan, since withholding taxes will result in leakage for the investor.

An investor should ensure that the manager knows where the investor is resident and knows of any special tax treaty benefits available to the investor. For example, Canadian pension plans may take advantage of article XXI (Exempt Organizations) of the Canada-US tax treaty. If a fund has investors in different countries, the manager will need to track the different jurisdictions and the relevant withholding tax rates to ensure that any withholding taxes applied to distributions are calculated correctly. The manager must ensure that it has the proper documentation in its records to demonstrate to the tax authority that it applied the correct withholding rates on distributions to non-residents. A Canadian manager may want to collect form NR301[46] from its non-Canadian investors so that it has documentation on hand showing that those investors are eligible for reduced Canadian withholding rates under a relevant tax treaty. Similarly, US-based private equity funds regularly require all of their investors to submit an IRS W-8 Series form, such as a W-8BEN-E,[47] to certify the investor's eligibility for reduced withholding rates on distributions from US portfolio investments.

Before investing in a fund, an investor will frequently request side letter provisions to ensure that (1) the investor is notified of any amounts of withholding taxes held against them; (2) the fund will provide any information required by the investor to obtain reductions or exemptions from withholding taxes withheld; and (3) the fund will make any filings or applications requested by the investor to obtain refunds of withholding taxes.

Basis Tracking and Income Allocation

Over time, a private equity fund will call capital from its investors as it makes investments and will pay distributions when investments are sold or exited. Since most funds are partnerships, the partnership will also allocate any income

(or loss) of the fund to its investors in accordance with its limited partnership agreement on an annual basis. Each of these actions will affect the ACB of the partnership units owned by the investor. The investor must track the ACB of its investment in order to avoid surprises, such as distributions from the partnership that exceed the ACB and thus result in a capital gain pursuant to subsection 40(3); and in order to enable the investor, upon a final windup of the partnership, to calculate the gain or loss on the disposition.

An investor should expect the fund to provide it with an annual (if not more frequent) summary of income allocated to it for tax purposes. For funds formed in Canada or managed by a Canadian manager, a T5013 ("Statement of Partnership Income")[48] slip is usually distributed. Funds managed outside Canada may distribute similar slips, such as a schedule K-1 for US-based funds. A fund established in another country may be subject to that country's reporting regime, and the tax authority of any such country may require that its own tax slips be used.

The annual tax-reporting slips and schedules generally form the basis of information used by the investor to report the income that it earned from the fund and to pay any applicable income tax in its home country. It is important for investors, when making an investment in a fund, to understand the type and timing of information to be delivered to them, in order to ensure that they will have the relevant information to complete their domestic reporting in a timely manner.[49]

Foreign Reporting (T1134/T1135)

As described above,[50] Canadian-resident investors must consider whether an investment in a fund will trigger an obligation to file form T1134 ("Investments in Foreign Affiliates") or form T1135 ("Investments in Specified Foreign Property").[51] Whether such an obligation is triggered will depend on many factors, including the residence of the fund entities, the size of the investor's investment in the fund relative to the fund size, and the types of investments the fund has made.

Generally, if a Canadian-resident investor invests in a Canadian fund that uses Canadian-resident fund entities, the fund entities will be responsible for any FA reporting since the fund entities are the lowest-tier Canadian entities in the chain of ownership. The Canadian investor may have to report its investment in the fund on form T1135.

If a Canadian investor invests in a fund that uses non-Canadian entities and the investor holds a significant portion of the interests in the fund, the investment may trigger FA reporting requirements for the fund. For example, a new manager raising its first fund may have only a few large investors, each holding a significant portion of the interests in the fund, and may miss the required FA reporting. If a fund's strategy is to invest in special types of equity, such as preferred equity, the FA reporting requirements may be triggered because the fund owns all or a significant portion of a specific class or series of shares, and the definitions of "foreign affiliate" and "controlled foreign affiliate" are tested on a per-class basis (a per-series basis if the class has more than one series).[52]

Secondary Transactions

Because private equity funds generally do not allow investors to redeem their investments before the end of the term of the fund, an investor wanting to liquidate its investment must find a buyer. Many of the issues to be considered by an investor in a primary transaction also arise for the buyer on a secondary transaction, particularly if the fund is not fully invested and is entitled to make additional investments. Additional issues also arise because the fund will likely have made one or more investments, each of which must be reviewed from a tax perspective: the original structuring will not have taken the tax needs of the buyer into account. For example, if there are no Canadian investors in the fund, it is unlikely that the anti-hybrid rules in the Canada-US tax treaty will have been considered. There will also be tax considerations relevant to the seller.

From a commercial perspective, the manager of a fund may not be involved in the sale process and will not know that a transaction is contemplated until the purchase agreement is concluded and the seller seeks the manager's consent to transfer. Reaching out to the manager for information to satisfy due diligence issues before the purchase agreement is concluded may therefore not be possible.

Understanding the Tax Exposure of the Fund and Its Investments

Transaction Structure of Portfolio Investments

Before entering into a definitive purchase agreement, a buyer will want to conduct a due diligence review of the structure of the fund and all of the investments made by the fund to date. A due diligence review of the fund structure generally involves reviewing the fund entities and understanding how returns from portfolio investments will flow through the fund into the hands of the investor. The considerations involved in this process include ensuring that the appropriate character of income is recognized and that leakage, such as withholding taxes, is minimized. In addition, the buyer will want to understand all of the tax- and information-reporting requirements that may be triggered in connection with its investment in the fund.

Has the Fund Employed AIVs and SPVs?

An often overlooked consideration in a secondary transaction is whether an AIV or SPV was used in making any of the fund's portfolio investments. The manager may have decided to invest through an AIV or SPV during the acquisition of investments, in order to address legal, tax, regulatory, or other considerations connected with the structuring of the transaction, or to address potential exposures such as foreign reporting or ECI.

It may be difficult to determine whether any AIVs or SPVs have been used by the fund or the seller, because a fund typically reports on a consolidated basis and does not identify which vehicle has been used by an investor. One way for

a seller to track all of the AIVs or SPVs that have been used is to collect all of the annual tax slips, such as T5013s or K-1s, issued by the fund. Because tax slips are issued on the basis of legal entities, one should expect to receive one slip from the fund itself plus additional slips from each AIV or SPV where the seller is a partner.

Year-End of the Fund

Because interests in private equity funds are not publicly traded and are not valued on a regular basis, secondary transactions typically close at the end of a calendar quarter to coincide with the quarterly close process for the manager. This is the time when a manager calculates each partner's capital account and allocates the results of the fund during that quarter.

Issues for the Seller

Subsection 100(1) of the Act

In general, a seller would take the position that its interest in the fund is a capital property such that a capital gain (loss) would be realized on the disposition. When the fund is a partnership, the seller must take into account the possible application of subsection 100(1) on the disposition of a partnership interest. If subsection 100(1) applies, the taxable capital gain realized on the disposition is deemed to be

1) 50 percent of such portion of the capital gain as may reasonably be regarded as attributable to increases in the value of any partnership property of the partnership that is capital property (other than depreciable property) held directly by the partnership or held indirectly by the partnership through one or more other partnerships, and
2) 100 percent of the remaining portion of that capital gain.

If there is a risk that that some or all of the fund's investments may not be capital property or are depreciable property, or if the fund has invested in other partnerships that hold property that may not be capital property or is depreciable property, the seller will want to ensure that a person described in subsection 100(1.1) does not acquire the interest in the fund as part of a transaction or event or series of transactions or events that includes the disposition of the interest in the fund. The persons described in subsection 100(1.1) include

1) a person exempt from tax under section 149;
2) a non-resident person;
3) another partnership to the extent that the interest in the fund can reasonably be considered to be held, at the time of its acquisition by the other partnership, indirectly through one or more partnerships, by (a) a person

that is exempt from tax under section 149, (b) a non-resident, or (c) certain trusts (excluding a mutual fund trust); and

4) a trust resident in Canada (other than a mutual fund trust) to the extent that it can reasonably be considered to have a beneficiary that is (a) exempt from tax under section 149, (b) certain partnerships, or (c) certain trusts (excluding a mutual fund trust).

A buyer should be prepared to represent (assuming that it is true) that it is not a person or partnership described in subsection 100(1.1). A hard negotiation may be needed to get the buyer to say more. The buyer might be prepared to represent that it does not have a current intention to transfer the purchased interest to a person or partnership described in subsection 100(1.1). However, a buyer may not be prepared to represent that no such person or partnership will acquire the interest as part of a transaction or event or series of transactions or events in which the seller disposes of the interest in the fund to the buyer; this is due to the meaning attached in *Copthorne Holdings Ltd. v. Canada*[53] to the phrase "in contemplation of the series" in subsection 248(10) (that is, the meaning that the phrase can be applied retrospectively as well as prospectively).

Potential Withholding Taxes

Section 116 Certificates

A buyer will ordinarily require the seller to represent that it is not a non-resident for the purposes of the Act or, if it is a partnership, that it is a "Canadian partnership." If the seller cannot give such a representation, it is necessary to determine whether the interest in the fund is "taxable Canadian property."

If the fund is a corporation, whether resident or non-resident, a share of the fund not listed on a designated stock exchange will be taxable Canadian property at a particular time if, at any particular time during the 60-month period that ends at that time, more than 50 percent of the FMV of the share was derived directly or indirectly (otherwise than through a corporation, partnership, or trust the shares or interests in which were not themselves taxable Canadian property at the particular time) from one or any combination of "(i) real or immovable property situated in Canada, (ii) Canadian resource properties, (iii) timber resource properties, and (iv) options in respect of, or interests in, or for civil law rights in, property described in any of . . . (i) to (iii), whether or not the property exists."[54] If the fund is a trust or partnership, a similar test is used to determine whether an interest in the trust or partnership is taxable Canadian property. In addition, a share or an interest in a trust or partnership can be deemed to be taxable Canadian property by other provisions of the Act.

If the seller cannot represent that it is not a non-resident for the purposes of the Act or, if it is a partnership, that it is a "Canadian partnership," and the interest in the fund is taxable Canadian property, the seller must generally obtain

a section 116 certificate in respect of the disposition. If an appropriate certificate cannot be provided at closing, the seller can expect that a properly advised buyer will withhold 25 percent of the purchase price[55] and that customary arrangements will be made to place the withheld amount in escrow.

FIRPTA

Section 897 of the Code generally characterizes gains derived by a non-resident alien individual or foreign corporation from the sale of a "US real property interest"[56] (USRPI) as US-source income that is effectively connected with a US trade or business and taxable to the non-resident alien individual or foreign corporation.

Section 1445 of the Code, commonly known as "FIRPTA," provides a set of rules under which a foreign transferor of a USRPI is subject to tax withholding and the transferee of the property is the withholding agent.

A USRPI is generally an interest in real property located in the United States or an interest, other than as a creditor, in a domestic corporation unless it is established that the corporation was at no time a "US real property holding corporation" (USRPHC) during the shorter of the five-year period ending on the date of disposition and the taxpayer's holding period. A corporation is a USRPHC if the FMV of its USRPI equals or exceeds 50 percent of the aggregate FMV of (1) its USRPI, (2) interests in real property located outside the United States, and (3) any other assets used or held for use in a trade or business.[57] If, on the date of disposition, a corporation does not hold any USRPI, and all of the interests held at any time during the shorter of the applicable periods were disposed of in transactions in which the full amount of any gain was recognized, an interest in the corporation is not a USRPI.

The transferee must deduct and withhold a tax on the total amount realized by the foreign person on the disposition. The rate of withholding is generally 15 percent, but there are a number of exceptions.[58] No withholding is required if the transferor certifies, under penalties of perjury, that the transferor is not a foreign person and provides the transferor's name, US taxpayer identification number, and home address (or office address, in the case of an entity).[59] No withholding is required if the disposition is of an interest in a domestic corporation and the corporation provides the transferee with a certification stating, under penalty of perjury, that the interest is not a USRPI.[60]

The amount of withholding can also be reduced pursuant to a withholding certificate issued by the IRS at the request of the transferor, transferee, or the transferee's agent. The IRS may issue a withholding certificate that reduces the amount of withholding if (1) the amount that must otherwise be withheld would exceed the transferor's maximum tax liability, (2) withholding of the reduced amount would not jeopardize collection of the tax, (3) the transferor's gain is exempt from US tax, or (4) the transferee or transferor enter into an agreement for the payment of tax, thus providing security for the tax liability.[61]

The IRS will generally act on applications for withholding certificates within 90 days after receipt of a complete application that includes the taxpayer identification numbers (TINs) of all of the parties to the transaction. The transferor is required to notify the transferee in writing that the certificate has been applied for on the day of or the day prior to the transfer.

ECI Partnerships

Prior to the passing of the Tax Cuts and Jobs Act of 2017,[62] the US tax consequences of a foreign person's sale of a partnership interest were not clearly defined, and withholding was not required. Amendments to the Code now impose both a substantive tax and a withholding obligation on foreign persons' sale of certain partnership interests.

If a non-resident-alien individual or foreign corporation owns, directly or indirectly, an interest in a partnership that is engaged in any trade or business within the United States, gain or loss on the sale or exchange of all (or any portion of) such interest is treated as effectively connected with the conduct of such trade or business to the extent that such gain or loss does not exceed the amount determined under section 864(c)(8)(B).[63]

The buyer of a partnership interest that is being sold by a foreign person is generally required to withhold 10 percent of the purchase price of the partnership interest[64] and remit it to the IRS no later than 20 days after closing.

Exceptions from withholding are provided if the transferor furnishes to the transferee an affidavit by the transferor stating, under penalty of perjury, the transferor's US taxpayer identification number and stating that the transferor is not a foreign person.[65] The amount of withholding can also be reduced, pursuant to a withholding certificate issued by the IRS, if withholding of the reduced amount would not jeopardize collection of the tax with respect to gain that is treated under section 864(c)(8) as effectively connected with the conduct of a trade or business within the United States.[66]

AIVs

If an AIV or blocker has been established to hold certain portfolio investments, the seller must transfer an interest in the AIV or blocker, as applicable, in addition to the seller's interest in the main fund. It is necessary to analyze each interest separately for the purpose of determining whether it is taxable Canadian property and whether section 864(c)(8)(A) of the Code applies, since the withholding tax implications apply on a legal entity basis.

Selling at a Discount

The seller of an interest in a fund may be required to accept a sale price that is less than the net asset value of the interest being sold, the discount being the cost

of liquidity. Provided that the buyer and seller deal at arm's length, paragraph 69(1)(b) should not apply to adjust the seller's proceeds of disposition.

Allocation of Income During Year of Sale

Neither the buyer nor the seller of an interest in a fund wants to be allocated income from the fund if it does not receive the corresponding distributions. If the fund is a corporation, this should not be an issue. The seller will be entitled to dividends or other distributions payable to shareholders of record on dates before the closing.

The same principle should apply if the fund is a co-ownership—that is, the seller should be entitled to its share of dividends or other distributions in respect of underlying securities held by the fund payable to security holders of record on dates before the closing. In practice, however, some co-ownerships do not allocate income on this basis. Rather, income is calculated as if the fund were a person and is allocated to holders of interests in the fund when the fund makes distributions.

If the fund is a partnership, the partnership agreement may provide that, in the case of a transfer of an interest in the fund, income (or loss) of the fund for that portion of the fiscal period ending before the transfer date is to be allocated to the seller, and it may provide for distributions in respect of such income to be made to the seller. In other cases, the partnership agreement does not provide for such an allocation, and only the buyer may be allocated a share of income for the year. In such cases, seller and buyer may agree to use reasonable efforts to request that the manager make a different allocation.

Allocation of Purchase Price

As discussed above, if an AIV or blocker has been established, the seller must transfer an interest in the AIV or blocker in addition to the seller's interest in the main fund. The purchase price must be allocated between the interest in the main fund and the interest in the AIV or blocker.

Deferral and Use of Leverage

In a conventional secondary transaction, the purchase price is paid on closing and is satisfied by the buyer's assuming any unfunded commitment of the seller and the payment of the balance in cash. In some cases, the purchase price may be paid in instalments. The timing of receipts will be important to the seller, because they affect the seller's internal rate of return (IRR) in respect of the original investment. A buyer may borrow to finance the purchase price. Interest should generally be deductible, assuming that the requirements under paragraph 20(1)(c) of the Act are satisfied.

Issues for the Buyer

Is the Buyer a Permitted Transferee?

As noted above, a manager is typically not involved in a secondary transaction and does not know that a transaction will take place until the purchase agreement is concluded. However, fund agreements usually provide that a manager has sole discretion to allow or reject a proposed transfer for any reason or for no reason. Once the purchase agreement is executed, the parties notify the manager so that the manager can begin the process of approving and registering the transfer of interests in the fund. If a transfer of interests is subject to a right of first refusal (ROFR) or similar rights, the manager will need to ensure that the ROFR process is completed before it agrees to the transfer. Buyers and sellers should be aware that these processes typically take time.

Before consenting to a transfer, managers generally request certain information about the buyer in order to complete their investor onboarding procedures, including "know your client" (KYC) procedures, anti-money-laundering (AML) procedures, and other relevant requirements based on the rules and regulations under which managers are governed. The manager will also review the fund documents to ensure that the proposed transfer does not contravene the constating documents of the fund and that the buyer can give the required representations regarding the type of investor allowed to be an investor in the fund.

At-Risk Amount

As discussed above, if the fund is a limited partnership, the at-risk amount is important because, if the investor is a limited partner of the partnership, the amount by which the investor's share of the amount of any loss of the partnership for a fiscal year from a business (other than a farming business) or from property exceeds the taxpayer's at-risk amount in respect of the partnership at the end of the fiscal period is not deductible in the year and will be treated as a "limited partnership loss." The limited partner's at-risk amount takes into account the ACB of the interest. However, a special rule applies in determining the at-risk amount of a limited partner that acquires its interest otherwise than from the partnership.[67] It provides that, for this purpose, the ACB of the interest is to be determined as if the buyer's cost were the lesser of its cost otherwise determined and its ACB to the transferor (or nil, if negative).

To comply with this rule, a buyer typically seeks the right to obtain tax information (such as T5013 slips issued to the seller) from previous years so that it will have the necessary information to calculate any effect on the at-risk amount. Alternatively, the buyer may require a representation from the seller as to the ACB of its interest.

Allocation of Income During Year of Sale

Although the allocation of income during the year of sale is relevant to both the buyer and seller in a secondary transaction, the manager determines the allocation of income between the buyer and seller on the basis of the rules set out in the fund documents. We have seen various methods of allocating income, including the following: (1) closing the books on the date that the transfer takes place; (2) allocating all of the income earned during the year of sale to the buyer; (3) allocating specific items of income to the buyer and seller on the basis of when the item of income was earned; and (4) prorating income amounts during the year of sale between the buyer and seller on the basis of the length of their hold period.

In some secondary transactions, a buyer and seller may agree in the purchase agreement that income earned by the fund during the year of sale should be allocated in a certain manner as between the buyer and the seller. However, since the manager is not a party to the purchase agreement, the method agreed to by the buyer and the seller is merely a suggestion to the manager, and the manager is not bound to follow it. Because private equity investing is relationship-based, a manager will usually consider the purchase agreement when it determines how income for the year should be allocated. If the agreed-upon method is permitted under the fund documents, the manager will typically allocate the income by the method preferred by the buyer and seller.

Transaction Taxes (Such as Stamp Duties)

Transferring units of a private equity fund may give rise to transaction taxes, such as stamp duties in the United Kingdom. It is often a negotiated point in the purchase agreement as to which party should bear the cost of transaction taxes, and it is important that buyer and seller perform due diligence to ensure that such taxes are appropriately dealt with in the fund agreements.

In certain cases, the buyer and seller may be able to avoid transaction taxes, such as stamp duties, by signing the agreement outside the country where such taxes apply and keeping the original signed documents outside that country. In each of these cases, it is important for a buyer to include indemnity clauses in the purchase agreement to address scenarios in which transaction taxes are unintentionally triggered if one party breaches the terms agreed to by the parties.

Tax Indemnity for Prior Periods

A buyer will want to ensure that it is indemnified in respect of all activities undertaken by the fund or the seller in tax periods before the interests in the fund are purchased. For example, a buyer may want to include an indemnity for the effect of previous years' audits, such as an audit under the BBA audit rules.

Publicly Traded Partnership Issues and Representations

Most funds prohibit transfers that could result in the fund being a publicly traded partnership under the Code, and a manager will deny a secondary transfer if the transfer may cause the fund to become a publicly traded partnership. Since the publicly traded partnership rules take into account how often interests in the fund are traded, it may not be possible for a buyer and seller to know whether the manager considers that the rules apply until notice is provided to the manager and the manager starts to review the transaction to decide whether to consent to the proposed transfer.

Conclusion

An investment by a Canadian investor in a private equity fund, whether in a primary or secondary transaction, requires careful attention to tax considerations. If appropriate, the investor may be able to negotiate specific contractual protections in a primary transaction. If not appropriate, the investor must rely on the manager's general obligation to take taxes into account in structuring transactions and to provide information sufficient for investors to file their own tax returns on a timely basis.

Notes

1 For example, see Jocelyn Blanchet, Neil Marcovitz, and Timothy Wach, "Structuring Private Equity, Infrastructure, and Hedge Funds," in *Report of Proceedings of the Sixty-Fifth Tax Conference*, 2013 Conference Report (Toronto: Canadian Tax Foundation, 2014), 28:1-36; and Peter Lee and Paul Stepak, "Private Equity Investments in Canadian Companies," in *Report of Proceedings of the Sixty-Ninth Tax Conference*, 2017 Conference Report (Toronto: Canadian Tax Foundation, 2018), 18:1-42; and Ash Gupta, Tim Wach, Jeffrey D. Uffner, and Susan R. Cohen, "Tax Issues in Structuring Cross-Border Private Equity Funds" (2009) 57:1 *Canadian Tax Journal* 23-49.

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

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

4 *Spire Freezers Ltd. et al. v. The Queen*, 2001 DTC 5158 (SCC); and *Backman v. The Queen*, 2001 DTC 5149 (SCC).

5 *Income Tax Technical News* no. 38, September 22, 2008, at 10.

6 CRA document no. 2016-0642051C6, May 26, 2016.

7 See CRA document no. 2013-0496831R3, January 2014.

8 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, November 2017) (herein referred to as "the OECD model tax convention"), at article 3, general definitions.

9 Subsection 12(3).

10 Subsection 12(9) and section 7000 of the Regulations.

11 Subsection 95(1).

12 Ibid.

13 Ibid.

14 CRA form T1134, "Information Return Relating to Controlled and Not-Controlled Foreign Affiliates (2011 and later taxation years)."

15 Pursuant to subsection 233.4(4).

16 Subsection 94.1(1).

17 *Gerbro Holdings Company v. Canada*, 2016 TCC 173; aff'd 2018 FCA 197.

18 Subsections 82(1) and 90(1).

19 Subsection 90(2).

20 Subsection 96(2.1).

21 Subsection 94(2.4).

22 IRS schedule K-1 (form 1065), "Partner's Share of Income, Deductions, Credits, etc."

23 See Paul Casuccio and Danny Cisterna, "The Changing GST/HST Landscape for Financial Services," in the 2017 Conference Report, supra note 1, 33:1-23.

24 Under the Code, tax-exempt organizations, including "qualified" pension plans, individual retirement accounts, foundations, and endowments, are subject to "unrelated business income tax" (UBIT) on their "unrelated business taxable income" (UBTI).

25 Under the Code, non-US investors that are engaged in a trade or business in the United States are taxed on their income that is "effectively connected" with that business, generally referred to as "effectively connected income" (ECI). Non-US investors that are engaged in a US trade or business are required to file US tax returns.

26 Subsections 102(1) and 248(1).

27 Subsection 2(3).

28 *Information Circular* IC72-17R6, "Procedures Concerning the Disposition of Taxable Canadian Property by Non-Residents of Canada—Section 116."

29 Subsections 142.2(3) and (4) provide additional interpretive rules.

30 Subsection 122.1(1).

31 Subsection 197(1).

32 See the definitions of "non-portfolio property" and "subject entity" in subsection 122.1(1).

33 In the case of a SIFT trust, because of subparagraph (ii) of the description of B in subsection 104(6), section 122, and the definition of "non-portfolio earnings" in subsection 122.1(1). In the case of a SIFT partnership, because of section 197.

34 See the definition of "public market" in subsection 122.1(1).

35 Subsection 122.1(1).

36 Ibid.

37 See the definition of "tax shelter" in subsection 237.1(1).

38 See the definition of "tax shelter investment" in subsection 143.2(1).

39 Subsection 102(1).

40 Government of Canada, "Certificate of Residency" (https://www.canada.ca/en/revenue-agency/services/tax/international-non-residents/information-been-moved/certificate-residency.html).

41 Bipartisan Budget Act of 2015, Pub. L. no. 114-74.

42 Section 6221 of the Code, sometimes referred to as the "BBA audit rules."

43 For example, a qualified foreign pension fund (QFPF) may be able to take advantage of an exemption from FIRPTA.

44 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, and July 29, 1997 (subsequently amended by a protocol signed on September 21, 2007) (herein referred to as "the Canada-US tax treaty").

45 Articles IV(7)(a) and (b) of the Canada-US tax treaty.

46 CRA form NR301, "Declaration of Eligibility for Benefits (Reduced Tax) Under a Tax Treaty for a Non-Resident Person."

47 IRS form W-8BEN-E, "Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)."

48 CRA form T5013, "Statement of Partnership Income."

49 Discussed in more detail above under the heading "How Will Tax Reporting Be Provided to Investors? Will It Be Canadian?"

50 Discussed in more detail under the heading "Foreign Affiliates."

51 See supra note 14 and CRA form T1135, "Foreign Income Verification Statement."

52 Subsection 248(6) provides that in its application in relation to a corporation that has issued shares of a class of its capital stock in one or more series, a reference in the Act to the "class" shall be read, with such modifications as the circumstances require, as a reference to a "series of the class."

53 2011 SCC 63; aff'g 2009 FCA 163; aff'g 2007 TCC 481.

54 Subsection 248(1), the definition of "taxable Canadian property."

55 As contemplated by subsection 116(5).

56 Code section 897(c)(1)(A).

57 Code section 897(c)(2).

58 Code section 1445(a).

59 Code sections 1445(b)(1) and (2).

60 Code sections 1445(b)(1) and (3).

61 Code section 1445(b)(4).

62 The Act To Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. no. 115-97, enacted on December 22, 2017 (commonly referred to as "the Tax Cuts and Jobs Act").

63 Code section 864(c)(8)(A).

64 Code section 1446(f)(1).

65 Code section 1446(f)(2)(A).

66 Code section 1446(f)(3).

67 Subsection 96(2.3).