A NEW TAX ON INVESTMENT FUNDS: DISTRIBUTIONS TO GENERAL PARTNERS (GPS) OF "INVESTMENT LIMITED PARTNERSHIPS" POSSIBLY SUBJECT TO GST/HST

Posted on October 2, 2017

Categories: Insights, Publications

In its continuing effort to "close the loopholes" in the Canadian tax system, the Canadian federal government has now taken direct aim at the investment management industry.

On September 8, 2017, the Department of Finance ("**Finance**") released a series of draft amendments to the *Excise Tax Act* (Canada) (the "**ETA**"), which include rules intended to impose GST/HST on distributions paid by an "investment limited partnership" (an "**ILP**") – a newly coined term – to its general partner (the "**GP**") (the "Proposed Amendments"). As ILPs will typically be engaged in providing exempt supplies of financial services, an ILP will generally be restricted from claiming input tax credits ("**ITCs**") to recover the GST/HST payable in respect of such distributions, thereby increasing the ILP's costs and reducing returns to investors.

The Proposed Amendments are open for public comment for a relatively short period of time. Comments must be submitted to Finance by **October 10, 2017**. However, once the Proposed Amendments are adopted, they will apply effective from September 8, 2017, meaning that all current structures will be impacted by these changes.

The Proposed Amendments

Under the current provisions of the ETA,[1] anything done by a person as a member of a partnership is deemed to have been done by the partnership in the course of the partnership's activities. Accordingly, administrative and management services[2] performed for a limited partnership by its GP are not generally considered to be taxable supplies of services by the GP to the limited partner.

The Proposed Amendments introduce the concept of an ILP, which is defined as a limited partnership, (i) the primary purpose of which is to invest funds in property consisting primarily of "financial instruments,"[3] and (ii) which satisfies one of the two following two tests:

1. The limited partnership is, or forms part of an arrangement or structure that is, represented or promoted as a hedge fund, investment limited partnership, mutual fund, private equity fund, venture capital fund or other similar collective investment vehicle (a "CIV"); or

2. The total value of all interests in the limited partnership held by "listed financial institutions"[4] is 50% or more of the total value of all interests in the limited partnership.

A proposed new subsection of the ETA[5] will deem management or administrative services provided by a GP to an ILP to:

1. not be provided by the GP as a member of the ILP; and
2. be provided otherwise than in the course of carrying on the ILP's activities.

Where a GP provides administrative or management services to an ILP, the ETA will deem the supply of such services to have been made for consideration equal to the fair market value of the services (determined as if the GP were dealing at arm's length with the partnership).[6] Given that management or administrative services provided by a GP to an ILP will be deemed to be provided for fair market value consideration at the time that they are supplied, GST/HST could be triggered on the fair market value of the administrative or management services provided by a GP without any actual payment being made to the GP by the ILP. In view of this result, a GP may need to become registered for the GST/HST, and to begin charging and collecting GST/HST from the ILP.

In addition, the Proposed Amendments will include legislative changes that may bring an ILP within the ambit of the "selected listed financial institution" ("**SLFI**") rules in the ETA, which would require the limited partnership to compute its ultimate GST/HST liability on its taxable costs based on the residence of its partners/investors.

Although the language in the Proposed Amendments is somewhat unclear, an ILP may include entities other than those enumerated in the definition of an ILP noted above, as the definition of an ILP includes both specific types of investment vehicles—namely, hedge funds, investment limited partnerships, mutual funds, private equity funds, and venture capital funds—as well as **other similar CIVs**. The term "collective investment vehicle" is undefined in both the ETA and the Income Tax Act (Canada),[7] and could accordingly be interpreted quite broadly for the purposes of the Proposed Amendments; however, it is worth noting that the wording used in the definition of an ILP is "other similar collective investment vehicles," which may limit the types of entities brought within the ambit of the definition of an ILP.

In addition, the fact that GPs will be **deemed** to be making taxable supplies to an ILP in respect of management or administrative services supplied to the ILP for fair market value consideration, irrespective of whether an equivalent amount of cash is actually payable by the ILP to the GP, could give rise to circumstances where GST/HST may be payable in respect of "phantom" consideration that may not ever be payable by the ILP. Moreover, burdens will now be imposed on GPs to value the management or administrative services provided to an ILP.

In sum, the Proposed Amendments may have a number of significant implications for investment vehicles, including:

i. the imposition on ILPs of unrecoverable GST/HST on the fair market value of the administrative or management services rendered by a GP;
ii. the requirement for GPs to register for GST/HST purposes;
iii. a reduction in after-tax returns to investors in ILPs; and
iv. the application of the SLFI rules to ILPs.

The complexity of the Proposed Amendments, and the fact that they are already in effect, means that investment vehicles structured as limited partnerships should contact their tax advisors to discuss their exposure as soon as possible.

by McMillan LLP

[1] Subsection 272.1(1) of the ETA.[ps2id id='1' target=''/]
[2] Under subsection 123(1) of the ETA, a “management or administrative service” includes an “asset management service”, which encompasses the full breadth of services an investment advisor or manager typically provides in the course of its operations.[ps2id id='2' target=''/]
[3] The term “financial instrument” includes equity and debt securities, insurance policies, and interests in partnerships or trusts.[ps2id id='3' target=''/]
[4] The term “listed financial institution” is generally considered to include banks, credit unions, insurers, lenders, traders or dealers of financial instruments, and investment plans, among others.[ps2id id='4' target=''/]
[5] Proposed subsection 272.1(8).[ps2id id='5' target=''/]
[6] Under subsection 126(3) of the ETA, a member of a partnership is deemed to be related to the partnership. Under subsection 126(1) of the ETA, related persons are deemed not to deal with each other at arm’s length. Under paragraph 272.1(3)(b), the consideration paid by a partnership for a supply of property or services is deemed to be equal to the fair market value of the property or service that is so acquired by the partnership at the time the supply is made.[ps2id id='6' target=''/]
[7] However, in Department of Finance (Canada), Technical Notes to subsection 270(1) of the Income Tax Act (October, 2016), the CRA notes that, for the purposes of the Income Tax Act, the term “collective investment vehicle” is used to describe funds that are “widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established.” However, the Technical Notes also state that “private equity funds and hedge funds would generally not fall within the scope of the definition of ‘collective investment vehicle,’” which stands in direct contrast with the proposed scope of the term in ETA.[ps2id id='7' target=''/]

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.