

STRUCTURING PRIVATE EQUITY REAL ESTATE FUNDS IN CANADA

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Overview

For money managers and real estate developers considering forming a private equity real estate fund in Canada there are a number of structuring features to consider. This bulletin provides a primer of certain key features for consideration.

Structuring and Key Considerations

Private equity real estate funds in Canada are typically structured as limited partnerships (“**Funds**”). Investors in Funds (the “**limited partners**”) purchase limited partnership units representing their respective indirect equity interests in the underlying asset(s). Typically, these Funds are closed-ended with capital raising occurring in one or more rounds of financing at the front end of a Fund’s lifecycle, with few (if any) redemptions of limited partners’ units during the term of the Fund and a fixed term which, depending on the nature of the underlying assets of a Fund, generally ranges from five to twelve years. In some instances, Funds have the ability to extend the term, typically in one or two year increments, in order to avoid forced liquidation if the market for the Fund’s assets is suboptimal. Alternatively, Funds may be open-ended, with capital raising occurring throughout the lifecycle of the Fund and opportunities for limited partners to redeem their units, subject to certain restrictions. Closed-ended Funds with underlying real estate assets continue to be more prevalent while open-ended Funds are less common (in practice, the illiquid nature of many real estate investments make the redemption feature associated with open-ended Funds less attractive to managers, with land transfer taxes in certain provinces creating a further obstacle to such a structure (in each case, as described in greater detail below)). The terms of the limited partnership are established in a limited partnership agreement.

A corporation, the shares of which are typically controlled by the principals that establish the Fund, is typically appointed as general partner of the Fund (the “**General Partner**”) and is responsible for day-to-day management of the Fund. If there are multiple principals of the Fund, the shares of the General Partner are often subject to an unanimous shareholders agreement which sets out the rights of the principals relating to the General Partner, including any board appointment rights, decision-making authority, economic interests

and how exits of principals from the project are to be managed efficiently.

Often the General Partner delegates the majority, or a portion, of its management responsibilities in respect of the Fund to an affiliated pre-existing or newly formed management entity (the "**Manager**"). The relationship between the General Partner and the Fund, on the one hand, and the Manager, on the other hand, is usually governed by a management agreement establishing the services the Manager provides to the Fund and the fees the Manager receives for providing these services.

The Fund typically holds its real estate assets, whether multifamily residential, office, industrial, hospitality, retail, healthcare or other, either directly or indirectly through one or more subsidiary limited partnership(s) on an asset-by-asset basis. Such subsidiary limited partnerships facilitate investment by investors (often institutions) seeking to invest solely in a specific asset of the Fund (as opposed to all of its assets) and to compartmentalize liability with respect to each underlying asset.

Funds typically operate subject to investment criteria or objectives established at Fund formation, specifying the types of assets in which the Fund may invest and the related rules.

In some instances, Funds create an advisory committee appointed by the General Partner, members of which are ideally at arm's length to the Fund and its principals. Unlike the General Partner or Manager that are responsible for the day-to-day Fund management, the role of advisory boards is solely advisory. Often, larger investors in the Fund will have appointment rights to an advisory committee. Advisory committees perform any number of functions including general oversight, addressing conflicts of interest, working with Fund auditors and ensuring compliance with, or granting waivers from, Fund investment objectives and criteria.

Capital Structure

In addition to traditional mortgages from banks or private lenders, Funds are capitalized by subscriptions for units in the Fund by limited partners, as well as mandatory or voluntary capital calls by limited partners under certain Fund structures (as described below). In some instances, Fund principals co-invest as limited partners, contributing their own capital to the Fund, demonstrating alignment with their investors.

Fund units are generally not "qualified investments" for registered plans including registered retirement savings plans ("**RRSPs**") and tax-free savings accounts ("**TFSAs**") under the Income Tax Act (Canada) (the "**ITA**"). Accordingly, Funds typically have a relatively small number of investors, frequently consisting of institutions and/or high net worth individuals for whom an investment being registered plan eligible is not necessary. In contrast, units of real estate investment trusts ("**REITs**") will generally be qualified investments for registered plans provided they have at least 150 unitholders and otherwise qualify as a "mutual fund trust" under the ITA. Accordingly, REITs typically have a higher number of retail investors than Funds. Please refer to our bulletin

about Practical Considerations for Structuring Private REITs [here](#).

Limited partners typically capitalize the Fund at its inception, i.e. when they are issued Fund units or alternatively their investment may be subject to capital calls by the Fund on an as needed basis up to the amount of their aggregate capital commitment. By utilizing a capital call structure, Funds are able to deploy capital only when needed, instead of sitting on large cash balances.

Given the illiquid nature of real estate assets and the lack of available free cash, especially at the early stages of the Fund, Funds typically limit or prohibit the ability of limited partners to redeem Fund units prior to the wind-up of the Fund. Open-ended Funds may permit the redemption of Fund units, subject to a number of restrictions, including specified lock-up periods when redemptions are prohibited, capping the aggregate value of units that can be redeemed during a specified period (typically quarterly or yearly) and financial penalties at that time of redemption. In addition, General Partners typically retain the ability to suspend redemptions or compel a limited partner to redeem their units upon the occurrence of events specified in the limited partnership agreement.

To avoid having the Fund taxed as a “SIFT partnership” under the ITA, which could result in material adverse tax consequences to the Fund and the limited partners, the Fund’s limited partnership agreement will often contain significant restrictions on the transfer of units in the Fund and will generally prohibit the listing or trading of such units on a “stock exchange or other public market”.

Returns to Investors and the “Promote” or “Carry”

Commonly referred to as the “waterfall”, how Funds distribute income and capital to the partners of the Fund is one of the seminal aspects of Fund structuring. Typically, limited partners in a closed-end Fund will only see a return on invested capital once underlying assets yield positive cash flow or upon the occurrence of a liquidity event, most typically the disposition of the Fund asset(s).

There is broad flexibility in structuring a “waterfall” in a limited partnership agreement. Typically, Funds first return capital to limited partners as a return of capital until limited partners have received their initial capital contribution. Funds may specify no distributions will be paid to limited partners until a certain period of time has passed in order to preserve Fund capital while assets are stabilizing. Second, limited partners will typically receive a preferred return, calculated annually, on their contributed capital. Third, provided the Fund has achieved the preferred return, the General Partner (or an affiliate of the principals that established the Fund) will typically receive distributions based on the performance of the Fund, commonly referred to as the “promote” or “carry”. Fourth, remaining income is typically split between the General Partner (or an affiliate of the principals that established the Fund) and the limited partners based on an allocation ratio set out in the limited partnership agreement. Often times, any distributions payable to the General Partner (or an affiliate of

the principals that established the Fund) are subject to a claw back to ensure total distributions paid to the General Partner (or an affiliate of the principals that established the Fund) are calculated based on the performance of the Fund throughout its entire life cycle as opposed to based on short term performance.

Fees

In addition to the promote, the General Partner or Manager may be paid management fees that, if the Fund is open-ended, are typically based on the net asset value (“NAV”) of the Fund or invested capital and, if the Fund is closed-ended, are typically based on committed capital and/or invested capital. In addition, the General Partner or Manager may receive any combination of fees payable upon the Fund acquiring or disposing of an asset, arranging for financing or for one of the Fund principals providing a personal guarantee for Fund financing (the latter ideally avoided unless necessary). Costs of Fund organization including accounting, audit, legal and marketing can be born by the principals of the Fund or in whole or in part passed onto limited partners. In addition, the General Partner and Manager are typically reimbursed for their reasonably incurred expenses when undertaking business activities on behalf of the Fund.

Generally under Canadian corporate and securities law there are no parameters or restrictions with respect to the carry or the fees the General Partner or Manager may charge to the Fund. Accordingly, the quantum of fees and distributions payable to the management team is generally a product of some combination of (i) market convention, (ii) what investors are willing to accept, and (iii) the track record of the Fund’s principals, i.e. the more experienced a management team, including a history of generating strong returns to investors, the more higher fees are justified.

Net Asset Value

In open-ended Funds, the General Partner or Manager calculate NAV of the limited partnership regularly (typically quarterly). This calculation is completed in accordance with an established valuation policy and is used to determine fees payable to the Manager, redemption value for units and to track overall Fund progress. In contrast, as outlined above, close-ended funds typically structure fees to the General Partner or Manager based on committed capital and/or invested capital (with the General Partner or an affiliate also typically receiving a carry from distributions).

Financial/Reporting Requirements and Dealers

Funds are not required under Canadian securities or corporate law to deliver unaudited interim or audited financial statements to limited partners; however, market practice, especially for well established Funds, is to provide limited partners with these financial statements. In addition, Funds may opt to provide limited partners with additional information including Fund performance reports, Fund expenses, the fair value of the

Fund's investments determined in accordance with the Fund's valuation methodology and general business updates.

Depending on the prospectus exemption relied on by the Fund to issue units to limited partners the Fund may be required to deliver a report of exempt distribution to Canadian provincial securities regulatory authorities within 10 days of each distribution or "closing" of Fund units.

Unlike REITs that are widely held and rely on registered securities dealers or exempt market dealers to sell REIT units, Funds do not typically retain dealers as they have fewer investors and those investors are typically within the existing network of the Fund's principals. Nonetheless, Fund management must ensure they are not engaging in activities deemed by securities regulators to be in the business of trading and therefore requiring registration under provincial securities laws.

Select Tax Considerations

Flow-Through Nature

Limited partnerships are generally not subject to income tax in Canada, but are instead generally treated as "flow-through" entities that must allocate income and loss earned in a fiscal period to their partners. Any such income or loss allocated to partners is generally taxed in the hands of the partners, with allocated losses potentially being available to partners to be set off against other taxable income of the partners' (subject to the detailed rules in the ITA).

Residency

A Fund's limited partnership agreement will typically require all limited partners to maintain tax residency in Canada for the duration of the investment to avoid having Canadian-source income earned by the fund being subject to Canadian withholding tax and to permit tax-deferred transfers of real property to the Fund (as described below). To address such limitation, non-resident investors seeking to invest in a Canadian limited partnerships will occasionally incorporate Canadian corporations to hold their partnership interest. Such a corporation would be a Canadian-resident taxpayer that is liable for Canadian income tax on its worldwide income (including income allocated to it by the Fund) and would be liable to file an annual Canadian federal income tax return and, in certain circumstances, tax returns in selected provinces. US investors frequently constitute such a holding corporation as an 'unlimited liability company' in order to capitalise on the flow-through character accorded to such entities for US federal income tax purposes. Funds that attract significant interest from non-resident investors will often establish two or more separate limited partnerships that act in parallel as so-called "feeder funds": one formed for Canadian investors and the other or others formed for non-Canadian investors.

Transfer of Real Property to Fund

In most circumstances, a Canadian resident taxpayer is permitted to transfer real property to a Fund on a tax-deferred “rollover” basis in exchange for units in the Fund on the filing of a tax election under subsection 97(2) of the ITA. A key requirement for such a tax-deferred rollover to apply is that none of the partners in the Fund is a non-resident of Canada for purposes of the ITA. As discussed above, limited partnership agreements typically restrict investors to Canadian residents in order to facilitate such tax-deferred transfers.

Land Transfer Taxes

Funds need to carefully manage exposure to provincial land transfer taxes. Certain provinces, including Ontario, generally apply land transfer tax on the basis that each of the partners of a partnership indirectly owns the partner’s pro rata share of any real property owned by the partnership. Accordingly, an acquisition of units in a Fund that already owns real estate in such a jurisdiction could give rise to a land transfer tax liability to the investing limited partner (as would a redemption of units in a Fund that caused the remaining limited partners to increase their proportionate interest in the Fund). Certain exceptions to such land transfer tax regimes could apply in connection with qualifying transfers of a *de minimis* interest in a partnership.^[1]

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If you have any questions regarding structuring a Canadian private equity real estate fund, members of McMillan’s Capital Markets Group, Private Equity Group, Tax Group and Real Estate Group would be pleased to assist you.

[1] See, for example, subsection 1(2) of *Ontario Reg. 70/91: Exemptions from Tax under Section 3 of the [Land Transfer Tax Act (Ontario)]*.

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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.

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