

# Canada

## Taxation

HEDGE FUNDS 2009

### Hedge fund managers/advisors

#### Taxation

##### Tax rates applying to hedge fund managers/advisors

A hedge fund manager/advisor that is a corporation is subject to income tax at a federal income tax rate of 19 percent in 2009. Provincial income tax rates vary from 10 percent to 16 percent. A manager/advisor that qualifies as a Canadian-controlled private corporation is taxed at a combined federal-provincial income tax rate of 16.5 percent on eligible active business income earned in Canada (generally to a maximum of CAD 400,000) assuming that it has a permanent establishment in a particular province. Hedge fund managers may be eligible to receive provincial tax incentives in the province of British Columbia or in the city of Montreal within the province of Quebec.

##### The effective tax rate usually suffered by hedge fund managers/advisors

Typically hedge fund managers/advisors do not have many permanent differences between income and expenses for financial statement purposes and those for tax purposes. Consequently the effective income tax rate is not significantly different than the statutory income tax rate. Like other types of corporations, hedge fund managers/ advisors are also subject to various taxes such as payroll taxes and provincial capital tax.

##### Tax concessions, allowances, or exemptions specifically available to hedge fund managers/advisors

There are no specific tax concessions, allowances, or exemptions applicable to hedge fund managers or advisors.

## Details of anti-avoidance tax rules that could bring the profits of an offshore hedge fund into tax

Hedge fund managers/advisors are taxed on management fees and incentive fees earned from the offshore fund. Where the hedge fund manager/advisor owns an investment in the fund, proposed legislation covering the tax treatment of certain types of foreign investments may apply for taxation years commencing after 31 December 2006. This legislation has not yet been enacted and is being reconsidered.

Generally, these rules are designed to accelerate the Canadian tax liability in the hands of taxpayers owning an interest in a vehicle meeting the definition of a foreign investment entity (FIE). Under the proposed new rules, income from an investment in a FIE will effectively be taxed under one of three income imputation methods each year even if it has not been distributed to the Canadian investor.

## Requirements to charge VAT (or equivalent sales tax) and the rate

Fees charged by hedge fund managers and advisors are generally subject to Goods and Services Tax (GST) of 5 percent as such services are not considered to be a GST exempt financial service. However, there could be an exception if the manager or advisor was the general partner of a limited partnership and performed these services as a member of the partnership. In this case the services would not be subject to GST.

## Hedge fund structures

### Taxation

#### Tax rates applying to the fund

A hedge fund may be structured as a corporation, trust or partnership. However, the most common forms are partnerships and trusts. Accordingly, only the taxation of trusts and partnerships are covered below.

One of the reasons for choosing a trust or a partnership as the vehicle for the fund is that they are both generally effective flow-through entities whereby the character of income and gains realized by the hedge fund flows through to the fund's investors and is generally taxed at the investor level only.

One of the major differences between trust and partnership structures should be noted. A trust is considered a separate taxpayer whereas a partnership is not. As a consequence, a partnership may flow through losses of the fund to the investors subject to limits (known as the at-risk rules and tax shelter rules) but a trust cannot.

## Trusts

Similar to other types of pooled investments such as mutual fund trusts, a hedge fund may be a unit trust if it satisfies a set of requirements. If additional criteria are met, the fund may also qualify as a mutual fund trust.

A hedge fund that is a trust is taxed at the highest income tax rate applicable to individuals, which is approximately 46 percent. In computing the trust's taxable income, 50 percent of realized capital gains (referred to as taxable capital gains) are included. Taxable capital gains can be offset by 50 percent of capital losses realized in prior years or in the three subsequent taxation years. Whether a particular gain or loss is on capital account or income account will depend upon the facts and circumstances and intentions of the fund. In some instances, it is possible for the fund to file an election to treat all gains and losses from Canadian securities as being on capital account.

Generally a unit trust will distribute all of its income so that it will not be subject to income tax. A mutual fund trust will typically distribute a sufficient amount of income so that the capital gains refund mechanism will offset any income tax otherwise payable.

A hedge fund trust that is not a mutual fund trust may also be subject to alternative minimum tax on certain types of income (such as capital gains and dividends from taxable Canadian corporations) that are subject to preferential tax rates.

## Partnerships

For Canadian tax purposes a partnership is not a separate taxable entity. Any taxable income or losses computed at the partnership level will be allocated to the partners and taxed accordingly even if the income is not distributed by the partnership to the partners.

## Specified investment flow-throughs

On 31 October 2006, the Department of Finance announced that a new tax on distributions from publicly traded income trusts and other flow-through entities (FTEs) such as limited partnerships, would take effect beginning with the 2007 taxation year for trusts and partnerships that began to be publicly traded after 31 October 2006. Existing income trusts and limited partnerships will not be subject to this new tax until their 2011 taxation year. These changes are intended to eliminate the tax advantage that unit holders that are non-residents or tax-exempt entities have over Canadian resident taxable investors in Canadian corporations.

Under this new regime, distributions by certain FTEs will be subject to tax in the FTE, the FTE will not be able to deduct the amount of the distributions of this income for tax purposes, and investors will be taxed as though the distributions were dividends. The FTE will pay tax on its non-deductible distributions at a special rate based on the federal-provincial corporate income tax rate.

### Access to double tax treaties

A double tax treaty should generally apply to avoid or relieve double taxation where the taxpayer is a corporation. However, the most recent protocol to the Canada-U.S. treaty introduced anti-hybrid provisions that may apply to deny treaty benefits to entities that are viewed as a flow through in one jurisdiction but not the other.

When applying double tax treaties to trusts or partnerships, it is critical to carefully review and interpret the relevant treaty provisions as the treatment may be different from treaty to treaty. For example, in the Canada-U.K treaty, a person means an individual, a trust, a corporation, and any taxable entity, but not a partnership whereas in the Canada-Spain treaty, a person includes a partnership.

Generally the view of the Canadian tax authorities is that treaty benefits flow through to partners where the partnership is viewed by both Canada and the other country as a transparent entity. The Canadian tax authorities are revisiting the issue of whether a partner resident in a treaty country is eligible for treaty benefits where the partner is not subject to tax in that country because the partnership is treated as a separate taxable entity by that country.

There are presently 87 double tax agreements signed and in force.

### Value-added tax registration and charging requirements

A hedge fund structure would only be required to register for purposes of the Goods and Services Tax and charge the tax to the extent it makes supplies of taxable services. Typically withdrawals, allocations, and distributions are not taxable services for GST purposes. The hedge fund structure may want to register in order to recover input GST if investing directly with non-residents.

### Withholding tax on dividends or interest payments

Any foreign taxes paid on income included in the income of a hedge fund that is structured as a trust is either deductible as an expense in arriving at income for tax purposes or (within specific limits) as a credit against Canadian taxes payable by the trust. If the foreign taxes are passed through the trust to the unit holders, they are deductible within limits by the unit holders as expenses or as a credit against Canadian income taxes. As noted above, a partnership is not a taxpayer for Canadian tax purposes. Accordingly, any foreign tax paid by

a hedge fund that is a partnership would be allocated to the partners and the partners would claim either a deduction or a tax credit.

In the context of payments made by a hedge fund trust, any income distributions paid or credited to non-resident holders are subject to 25 percent withholding tax. The tax rate may be reduced to the rate applicable to trust income by virtue of a treaty negotiated between Canada and the country in which the holder is resident. However, any realized capital gains distributions are generally not subject to withholding tax unless the gains are from the disposition of taxable Canadian property by a mutual fund trust.

Unlike income distributed by a trust, income distributed by a partnership retains its character as interest, dividends, etc. In that regard, Canadian tax should not apply to most interest paid to an arm's length non-resident on or after 1 January 2008. However, participating debt interest and interest paid to a non-arm's length non-resident are still subject to withholding tax. Other types of income distributed by a partnership may be subject to the 25 percent withholding tax rate unless a treaty provides relief.

Where the fund is a partnership that has one or more partners that are non-resident, the partnership is viewed as being a non-resident for certain purposes. As a result, most investment income paid to the fund by Canadian residents should be subject to Canadian withholding tax.

### Tax return requirements

For taxation years ending after 3 July 2007, publicly traded trusts and partnerships must disclose to their investors and the Canadian tax authorities information about their income and capital distributions and allocations within 60 days (67 days for publicly traded investment trusts and partnerships that invest in other publicly traded trusts, partnerships, or corporations) after the end of a given taxation year. Trusts that are not publicly traded have until 90 days after 31 December to make these disclosures. The deadline for partnerships that are not publicly traded will depend upon whether the partners include any individuals or trusts. If so, the deadline is the same as for trusts that are not publicly traded. If not, the deadline is 5 months after the taxation year of the partnership.

The fund must also file a tax return. Trusts must file a T3 Trust Income Tax and Information Return along with related schedules and statements no later than 90 days after the trust's tax year-end, which must be 31 December.

Despite the fact that a partnership is not considered a taxpayer, a fund structured as a partnership must file a T5013 Partnership Information Return along with related information slips and schedules. The filing deadline depends on the nature of the partners. Where one or more partners are individuals or trusts, the partnership must have a tax year end of 31 December and the partnership return is due by the end of March of the subsequent year. Where

all the partners are corporations, the partnership can choose any date as its taxation year end and the partnership return is due no later than five months after the fiscal year end.

If the hedge fund has investors that are resident in the province of Quebec, the Quebec version of the T3 and T5013 returns and slips must be filed, as well.

## Investors

## Taxation

### Specific anti-avoidance tax legislation applying to an investor in an onshore fund

There are no specific anti-avoidance tax rules that apply solely to investors in hedge funds. However, there are other anti-avoidance rules that may apply to prevent income splitting among family members and triggering unrealized losses.

Any income on property transferred between certain related persons is subject to attribution rules whereby all income earned on the transferred property will be attributed back to the original holder who then will be taxed accordingly. For example, where an investor transfers fund units to his or her spouse and those units generate CAD 1,000 of trust income, the trust income will be included in the taxable income of the investor who transferred the fund units. There is an exception to the attribution rules where a taxpayer transfers property for fair market value consideration.

A superficial loss arises where a taxpayer that is an individual sells an investment in a fund to trigger a capital loss and the taxpayer or his/her spouse or a corporation controlled by either person acquires an identical investment within 30 days before or after the sale. The loss realized will be denied and added to the cost of the identical property. Similar rules apply to corporations, trusts, and partnerships that transfer property with a pregnant loss to an affiliated person. However, rather than the loss being added to the cost base of the identical property, it is suspended and can only be claimed by the transferor when the property is no longer in the affiliated group.

Canadian tax legislation also contains a general anti-avoidance rule, applicable to all transactions, to prevent any misuse or abuse of Canadian tax legislation.

### Specific anti-avoidance tax legislation applying to an investor in an offshore fund

As noted above under Details of anti-avoidance rules that could bring the profits of an offshore hedge fund into tax, new tax rules have been proposed to

prevent Canadian taxpayers from deferring investment income earned on foreign investments.

Generally, these rules are designed to accelerate the Canadian tax liability in the hands of taxpayers owning an interest in a vehicle meeting the definition of a foreign investment entity (FIE). Under the proposed new rules, income from an investment in a FIE will effectively be taxed under one of three income imputation methods each year even if it has not been distributed to the Canadian investor.

### Tax information needs of investors

Investors in onshore funds will receive tax reporting slips (T3, T5, or T5013 slips) to notify them of the amounts to include when computing taxable income. Investors are responsible for calculating the adjusted cost base of their investment and adjusting it for returns of capital, reinvested distributions, etc.

Investors in offshore funds will require information from the funds regarding the nature of any distributions received. In addition, if the offshore fund is a partnership, Canadian investors will require information regarding the underlying fund investments in order to comply with the FIE rules described above. Investors in both onshore and offshore funds will need to know whether any distributions represent returns of capital rather than income distributions in order to adjust the tax basis of their investment.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.