THE CANADIAN BAR ASSOCIATION
L'ASSOCIATION DU BARREAU CANADIEN

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Via email: Sean.Keenan@canada.ca; fin.gsthst2017-tpstvh2017.fin@canada.ca

Sean Keenan
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90 Elgin Street
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Dear Mr. Keenan:

Re: GST/HST Amendments – Investment Limited Partnerships

The Canadian Bar Association's Commodity Tax, Customs and Trade Section (CBA Section) is pleased to comment on the draft amendments to the *Excise Tax Act* (Canada) (ETA) relating to "investment limited partnerships" (ILPs) announced on September 8, 2017 (the Announcement Date). In particular, we comment on proposed subsection 272.1(8) of the ETA and related provisions.

The CBA is a national association representing over 36,000 jurists, including lawyers, notaries, law teachers and students across Canada. We promote the rule of law, access to justice, effective law reform and provide expertise on how the law touches the lives of Canadians every day. The CBA Section comprises lawyers from across Canada who work on commodity tax, customs and trade remedy matters.

Introduction

The Explanatory Notes to the draft legislation state that proposed subsection 272.1(8) "clarifies" that, even if a general partner of a partnership provides management or administrative services to the partnership pursuant to its obligations as a member of the partnership, the provision of the service is deemed not to be done by the general partner as a member of the partnership. In addition, the supply of the service by the general partner is deemed to have been made otherwise than in the course of the ILP's activities.

The clear intent of the proposed amendment is to levy unrecoverable GST/HST on management or administrative services provided by general partners to partnerships engaged in investment activities. However, as explained below, the proposed amendments create significant uncertainty.

We believe that this uncertainty must be addressed if it is decided to implement the proposed amendments.

Definitions

Proposed subsection 272.1(8) will apply to general partners of ILPs. The proposed definition of ILP in subsection 123(1) of the ETA creates several interpretation challenges.

(i) Primary Purpose

A limited partnership is defined to be an ILP if, *inter alia*, its primary purpose is to invest its funds in property consisting primarily of financial instruments. This raises the difficult question of how the "primary purpose" of the partnership is to be determined. For example, will the determination be based on:

(a) the stated objectives of the partnership

(b) the time spent by the partnership in its activities

(c) the assets of the partnership

(d) supplies made by the partnership

(e) the income for income tax purposes of the partnership or

(f) some combination of these factors

The same conceptual issues are raised by the requirement that the partnership's assets must consist "primarily" of financial instruments. "Primarily" in this context requires a comparison of the partnership's properties (as between financial instruments and non-financial instruments). However, there are several possible bases for comparison in the context of the wide variety of activities undertaken by partnerships in Canada. Again, will "primarily" be determined based on the cost of the assets, the value of the assets from time to time, the number of the assets, or a combination of these criteria?

For example, we can consider the following scenario:

1) Partnership ABC is established on January 1, 2018 with the purpose of investing directly or indirectly in commercial real estate;

2) Partnership ABC's first investment, made on February 1, 2018, is the payment of $1,000,000 to acquire a 99.9% interest in another partnership whose sole asset is a commercial building which the second tier partnership rents to tenants (and charges the applicable GST/HST);

3) On August 1, 2018, Partnership ABC makes a second investment of $2,000,000 directly in commercial real estate;

4) On December 31, 2018, the direct investment in real property has decreased in value to $500,000, while the value of the initial indirect investment in real property remains the same.

This situation raises the following questions:

- Will Partnership ABC never be an ILP on the basis that its primary purpose is not to invest its funds in property consisting primarily of financial instruments?
- Will this be the case even if all of Partnership ABC's assets are in financial instruments such as partnerships (i.e. on February 1, when it only owns a partnership interest)?
- If Partnership ABC is considered an ILP on February 1, on the basis that all of its assets are financial instruments, will Partnership ABC cease to be an ILP on August 1 after the second investment is made and 2/3s of its assets are directly in commercial real estate?
- If so, does Partnership ABC cease to be an ILP again on December 31 when the fair market value of its financial instruments are more than 50% of the total value of its assets?

Given the significant different consequences of being or not being an ILP, additional clarification on the manner of applying the primary tests is desirable.

(ii) Timing of Status

The proposed definition of "ILP" does not state whether it applies at a particular time or is to be determined at a specific point in time for a particular partnership. A partnership's activities and assets and the composition of its members may change from time to time. We recommend that the definition be clarified so that it applies at any particular time to a partnership.

(iii) Financial Instruments

The proposed definition of "financial instrument" in subsection 123(1) of the ETA includes, *inter alia*, debts, shares of corporations, interests in partnerships and units of trusts.

It appears that the definition of ILP is not intended to include a partnership that carries on a business that does not relate directly to investments in financial instruments, for example, a partnership that owns or invests in commercial or residential real estate. However, investments in partnerships that own real estate often occur through tiers of partnerships. In these circumstances, from a GST/HST perspective, the upper tier partnership will be considered, in respect of its investment in the lower tier partnership, to have invested in a financial instrument, rather than the underlying real property. Consequently, depending on how the primary purpose test above is determined, the upper tier partnership could be an ILP.

This result appears unintended and overly broad, especially in circumstances where the upper tier partnership owns a significant interest in the lower tier partnership. Consider the example of Partnership XYZ that invests in commercial real estate. Partnership XYZ wishes to own two properties in partnership with two different persons who will be minority investors in one or the other property. For commercial protection and income tax efficiency, Partnership XYZ forms two lower tier partnerships in which it is the majority interest partner. Each different minority partner owns an interest in one or the other lower tier partnership that hold the properties.

Although Partnership XYZ's underlying investment is entirely in commercial real estate held through its majority interest in each lower tier partnership, Partnership XYZ could be considered to be an ILP under the proposed definition of ILP. This result seems inappropriate given the underlying commercial activity, and would create unwarranted burdens on ordinary course business transactions.

This potential result for tiered partnerships appears particularly inappropriate when contrasted to the GST/HST relief provided in corporate structures. While the proposed ILP rules could cause unrecoverable GST/HST to be payable on management fees where the partnership owns controlling interests in underlying entities carrying on a commercial activity, section 186 of the ETA is

specifically designed to eliminate unrecoverable GST/HST on management or administrative services provided to a holding corporation in a corporate structure in which there is underlying commercial activity in its corporate subsidiary. The difference in treatment is difficult to rationalize.

(iv) Commercial Terms

Paragraph (a) of the proposed definition of ILP states that a partnership is an ILP if it "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 similar collective investment vehicle".

We have the following comments:

1) Using the term "investment limited partnership" in the definition of "investment limited partnership" is circular and also creates significant uncertainty.

2) The use of undefined terms such as "hedge fund", "mutual fund" and "private equity fund" creates uncertainty given the myriad of investment vehicles and naming conventions that exist in the current financial investment world.

3) "Forms part of" is an imprecise phrase without legal meaning. Is this phrase intended to be interpreted as "part of" in the legal sense, as in "is a member of", or "owns an interest in", or is it intended to be a more general concept? Given that the law of Canada is based on legal form, it is difficult to determine the meaning of "forms part of".

4) The same concerns apply to the words "arrangement or structure". Are those words intended to mean legal arrangements or structures or something broader? Given the concern expressed above about tiered partnerships, the words "arrangement or structure" creates additional uncertainty.

(v) Partnerships Activities are Different

The proposed legislation appears to apply to a wide range of partnerships. However, partnership investment activities can be quite different. For example, many private equity or venture capital funds acquire significant interests in private corporations or business in other forms and are actively involved in the management of the underlying business. These forms of partnership are significantly different than a partnership that has a portfolio interest in publicly traded shares and does not take any role in managing the underlying business.

We believe that the ILP rules, if implemented, should not apply to the types of partnerships described in the preceding paragraph, or similar investment structures where the ILP is involved in operating an underlying business.

Grandfathering

Although the Technical Notes state that the proposed amendments are "clarifying", the reality is that they are not. The proposed amendments are inconsistent with existing partnership law and income tax law. Under common law, a partner's activities undertaken in the course of a partnership's activities are not provided to the partnership, they are provided as a member of the partnership. Pursuant to the partnership agreement, a partner is entitled to a share of the partnership's profits as compensation for those activities.

Subsection 272.1(1) reflects this well-understood legal relationship. Subsection 273.1(3) addresses supplies made outside of the partnership's activities. For example, a partner in a law partnership could own the land on which the partnership's office is located. The partner could rent the land to the partnership, which subsection 273.1(3) would deem to be a separate supply.

The proposed amendments create general unfairness by applying to activities performed and services provided by a general partner after the Announcement Date in partnerships that were formed many years before Announcement Date.

Countless limited partnerships were formed prior to the Announcement Date based on these well-understood principles and the current section 272.1. It is inappropriate to impose an unexpected additional GST/HST cost on these partnerships, as they were formed in good faith based on a sound interpretation of the ETA and partnership law.

We recommend that grandfathering be extended to all limited partnerships formed prior to the Announcement Date, so that proposed subsection 272.1(8) does not apply to these partnerships, unless there is a substantial amendment to the partnership agreement after the Announcement Date.

Coming Into Force

If full grandfathering (as proposed above) is not included, paragraph 41(4)(a) of the amending legislation should be clarified to ensure that the proposed amendments apply only to supplies of services made by a general partner after the Announcement Date.

Paragraph 41(4)(a) states that proposed subsection 272.1(8) applies to consideration for a supply of services where the consideration becomes due after the Announcement Date. This appears intended to incorporate the rule in subsection 272.1(3) into the proposed amendments, which deems the consideration for the supply of a service by a partner to a partnership to become due at certain times. In particular, where the partnership is not engaged exclusively in commercial activities, subsection 272.1(3)(b) deems consideration for a service provided by a partner to become due when the service is rendered.

As a matter of fairness, the grandfathering rule must be as clear as possible. We believe that paragraph 41(4)(a) of the amending legislation should be clarified by stating:

> (a) any consideration for a supply of the service becomes due (within the meaning of subsection 273.1(3) of the ETA) […]

In addition, subsection 41(4) of the amending legislation should be amended to clarify that all services provided by a general partner on or before the Announcement Date are deemed to be a supply of a service that was completed on or before the Announcement Date, separate and apart from any supplies made after Announcement Date.

Collecting and Reporting

Paragraph 272.1(3)(b), which is intended to apply to ILPs, will deem consideration for the supply of a general partner's service to become due at the time the service is rendered. Pursuant to subsection 168(1) of the ETA, GST/HST will generally become payable at the time the service is rendered, even if the general partner is not entitled under the partnership agreement to receive compensation in respect of such service until sometime later.

This creates several issues. First, a general partner may provide management and administrative services on a daily basis. Arguably, subsection 273.1(3) could cause GST/HST to be due and payable each day. Second, the deemed supply applies only to management or administrative services. This raises an interpretation issue: is the general partner making separate supplies of management or administrative services to which the GST/HST can attach, or making a continuing supply of one service. This issue is particularly problematic in an existing partnership where the application of subsection 273.1(3) was not contemplated. Third, the general partner's obligation to charge and collect GST/HST will not necessarily match the timing of payments for that service from the partnership, especially in partnerships established before the Announcement Date. In that case, there is no basis in the partnership agreement to facilitate the general partner's GST/HST collection obligations.

The interaction of subsections 272.1(8) and 272.1(3), which make GST/HST payable on the fair market value of the management or administrative services provided by the general partner to the ILP, raises obvious valuation issues. The fair market value of the particular services provided by the partner will have to be determined using a market comparable which may not be easily determined or available.

Finally, additional complexity is created where the general partner performs many different activities and provides many services pursuant to the partnership agreement. Existing partnership agreements may not specify the nature of the various activities or services. Therefore, identifying the predominant nature of the general partner's activities or services, and whether a separate management or administrative service can be identified in the bundle of activities performed and services provided by the general partner, is problematic.

If GST/HST is to be imposed on deemed (if not phantom) supplies, at minimum, we recommend that section 168 be clarified to provide that GST/HST is collectible by the general partner annually or every fiscal quarter to provide certainty and administrative convenience.

Thank you for the opportunity to comment on the draft amendments to the Excise Tax Act (Canada) relating to investment limited partnerships.

Yours very truly,

(original letter signed by Marc-Andre O'Rourke for Alan Kenigsberg)

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