

# Canada

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## **1. REGULATION OF FUNDS**

### **1.1 Funds domiciled in the jurisdiction**

#### **1.1.1 Brief overview of fund regulatory regime**

##### **Name of regulator**

There is as yet no national securities regulator in Canada, which is a federation of 10 provinces and three territories. Laws made under the federal jurisdiction, such as those in relation to federal income tax, have application in all provinces and territories. Other matters, such as those in relation to property and civil rights, are within provincial jurisdiction and each province has its own laws in those areas. This includes securities regulation and each province and territory has its own securities regulatory authority. In the Province of Ontario, for example, it is the Ontario Securities Commission. As a group, the provincial and territorial securities regulators are referred to as the Canadian Securities Administrators (CSA). In this chapter, a province or territory of Canada is sometimes referred to as a 'local jurisdiction'. The federal government has referred a draft federal securities act to the Supreme Court of Canada for an opinion on its constitutionality. This draft legislation includes the concept of a federal securities regulator.

##### **Statutes/policies under which funds are regulated**

Each Canadian province and territory has its own securities legislation and, while the legislation is not uniform, there is a good measure of consistency in the approaches of the local jurisdictions. There are also many rules that have been adopted in all provinces and territories and are known as National Instruments.

There is no definition of 'hedge fund' in Canadian securities legislation. In commenting on hedge funds in a 2007 notice regarding them, the CSA staff referred to them broadly as 'investment pools that use alternative investment strategies not generally available to traditional mutual funds such as taking both long and short positions and using arbitrage, leverage, options, futures, bonds and other financial instruments to capitalise on market conditions'.

A 'mutual fund' under Canadian securities legislation is a fund whose primary purpose is to invest money provided by its investors and the securities of which are redeemable on demand, or within a specified period after demand, by the investor at an amount computed with reference to the value of a proportionate interest in the whole or part of the net assets of the fund. An 'investment fund' is a mutual fund or a 'non-redeemable

investment fund', being an issuer whose primary purpose is to invest money provided by its investors that does not invest for the purpose of exercising control of an issuer or for the purpose of being actively involved in the management of any issuer in which it invests. A hedge fund would be an investment fund and could fall under the 'mutual fund' branch if structured with a redemption feature that met the requirements for mutual fund status.

Traditional mutual funds are typically offered by prospectus to retail investors and are governed by a number of specific rules that prescribe particular prospectus disclosure and set out, among other things, requirements concerning the investments that they are permitted to make, restrictions on leverage and various investment practices and custody. Non-redeemable investment funds, including hedge funds structured as such, offered by prospectus are subject to the general prospectus rule applicable to all types of issuers and are subject to requirements on custody, but not other specific rules governing their permitted investments. All investment funds that are 'reporting issuers' (which status results from their offering by prospectus or being listed on an exchange in the local jurisdiction) are subject to rules concerning continuous disclosure and requirements for an independent review committee, being National Instrument 81-106 – Investment Fund Continuous Disclosure (NI 81-106) and National Instrument 81-107 – Independent Review Committee for Investment Funds (NI 81-107). Investment funds offered by prospectus that are not mutual funds would typically be listed on an exchange in Canada.

Most hedge funds are sold in Canada by private placement. There are no specific rules that apply to hedge funds sold on a private placement basis that regulate their investment activities or how they operate, although a privately placed hedge fund that is organised under the laws of certain provinces, including the Province of Ontario, and is a 'mutual fund' is required to provide investors with continuous disclosure under certain parts of NI 81-106.

Persons or companies involved in the management of hedge funds, the provision of portfolio management services to hedge funds and the offering of hedge fund securities to investors in Canada are subject to regulation. As of 28 September 2009 a new harmonised registration regime came into force in all Canadian provinces and territories. This regime requires that a person or company engaging in or holding itself out as engaging in the business of selling securities as principal or agent be registered as a dealer, that a person or company engaging in or holding itself out as engaging in the business of advising others as to the investing in or the buying or selling of securities be registered as an adviser and that a person or company that directs the business, operations or affairs of an investment fund be registered as an investment fund manager. The key rule under the new regime is National Instrument 31-103 – Registration Requirements and Exemptions (NI 31-103), expected to be renamed Registration Requirements, Exemptions and Registrant Obligations in July 2011, which sets out the categories of registration, the proficiency, capital, insurance and other basic requirements for registration, the ongoing requirements regarding internal controls

and systems, financial condition and reporting, dealing with clients and handling client accounts. The requirement that investment fund managers (including the managers of hedge funds) register is new.

### **Statistics on number of funds established and their regulatory classification as at 30 June 2009**

There are no official statistics on the number or size of Canadian hedge funds. In an 18 May 2005 publication entitled *Regulatory Analysis of Hedge Funds*, the Investment Dealers Association of Canada (now known as the Investment Industry Regulatory Organisation of Canada or IIROC) cites Investor Economics, a Toronto-based research firm, as estimating that there were C\$26.6 billion in Canadian hedge fund assets as at June 2004. The Investment Funds Institute of Canada, the industry's trade association, has noted that assets under management by Canada's investment funds industry, which includes mutual funds, segregated funds, hedge funds and private pools, was estimated at C\$743.7 billion at 30 June 2009.

#### **1.1.2 Expert/professional investor fund regimes Essential requirements to qualify for the regime**

Hedge funds are generally sold to investors by private placement rather than by prospectus. In conjunction with the new registration regime that came into force in Canada on 28 September 2009, the prospectus exemptions have been restated, principally in the amended and restated National Instrument 45-105 – Prospectus and Registration Exemptions (NI 45-106). The prospectus exemption most commonly used to place hedge fund securities is the 'accredited investor' exemption, which permits the distribution of a security to a purchaser without a prospectus where the purchaser purchases as principal and is an 'accredited investor'. The definition of 'accredited investor' in the restated NI 45-106 includes institutional investors and high net worth individuals.

#### **Registrations/permits/licences required**

There are three types of registration that are relevant for hedge funds. The dealer registration requirement, the adviser registration requirement and the investment fund manager registration requirement.

Prior to the implementation of the new registration regime in Canada, the requirement to register as a dealer was triggered by trading in securities and there were dealer registration exemptions under the securities legislation of all local jurisdictions that paralleled the prospectus exemptions. Accordingly, there was a dealer registration exemption for trades with 'accredited investors'. The exception to this situation was in the Provinces of Ontario and Newfoundland and Labrador where most dealer registration exemptions were removed for 'market intermediaries', being persons or companies in the business of trading in securities in such province as principal or agent other than in securities purchased by them for their own account for investment and not with a view to resale or distribution.

Under the new registration regime, the trigger for the dealer registration

requirement is being in the business of trading in securities as principal or agent, not merely trading. The old dealer registration exemptions, including for trading with 'accredited investors', were removed in all local jurisdictions as of 27 March 2010. After this date a person in the business of trading in securities as principal or agent is required to be registered as a dealer in the provinces or territories in Canada where it is so trading. There are limited exemptions. Issuers such as hedge funds could be caught by this requirement, but the matter is very fact specific. NI 31-103 includes a dealer registration exemption for trades by a person or company if the trade is made solely through an agent who is a registered dealer, if the dealer is registered in a category that permits the trade. A fund that hires an appropriately registered dealer to distribute its securities should have the benefit of this exemption. The CSA have cautioned, however, that the exemption is not available where a person conducts trading activity for which they are not registered and then directs the execution of the trade through a registered dealer. Under the new regime, a dealer can register in the 'exempt market dealer' category that authorises it to trade in circumstances where a prospectus exemption would be available, with 'accredited investors' for example. The 'investment dealer' category of registration permits the dealer to trade with all types of investors in all types of securities and requires that the dealer be a member of IIROC, which is the self-regulatory organisation for such dealers.

A person or company providing portfolio management services for, or other investment advice to, the hedge fund would need to be registered as an adviser in the local jurisdiction where the hedge fund is receiving the advice, which would typically be where the fund is managed. The regulation of futures and derivatives differs among the local jurisdictions and there is separate commodity futures legislation in the Provinces of Manitoba and Ontario and a separate Derivatives Act in Quebec, all of which include dealer and adviser requirements for trading in and advising on futures, and derivatives in the case of Quebec. 'Exchange contracts' are covered under the Securities Acts in Alberta, British Columbia, New Brunswick and Saskatchewan, but regulated in some aspects differently from 'securities'. New Brunswick also has a new local derivatives rule under its Securities Act that addresses registration requirements for trading in derivatives, including 'exchange contracts'. Depending on the nature of the hedge fund's investments and where it is managed, persons providing investment advice or trading with the hedge fund itself could require registration under these other legislative provisions.

The new registration regime includes the requirement that a person directing the business, operations or affairs of an investment be registered as an investment fund manager. This would include the manager of a hedge fund. If such manager were already registered as an adviser, it would still need to register in the investment fund manager category.

### **Documents required to be filed**

A fund that relies on the accredited investor prospectus exemption when issuing its securities is required to file a report of trade in Form 45-106F1

with the securities regulatory authority in the province or territory where the investor resides within a prescribed time period after the trade and pay a filing fee. In some but not all local jurisdictions, for a number of prospectus exemptions, if the investor is provided with an offering memorandum the issuer or underwriter is required to deliver a copy of the offering memorandum to the securities regulator in the province.

### **Regulatory timescales**

There are no regulatory time periods associated with the offering of securities of the hedge fund by private placement, but if any of the parties involved are not registered with the securities regulators and are required to register, such registration generally would be required to be obtained before the offering could proceed.

### **Registration/permit/licence fees – initial and ongoing**

The filing fees payable by an issuer filing a report of trade on the sale of its securities to investors vary among the local jurisdictions. In some jurisdictions the fees are a nominal amount and in others they are based on a percentage of the amount raised. For example, in the Province of British Columbia they are the greater of 0.03 per cent of the aggregate gross proceeds realised there and C\$100.

Similarly, the fees payable by registrants in the local jurisdictions in which they are registered vary. In some cases, they are based on a fee for the firm and for the individuals registered under the firm and in others they are based on the revenue in the jurisdiction. For example, in the Province of Ontario, registrants and unregistered capital markets participants pay annual participation fees on a sliding scale based on their gross revenues attributable to capital markets activities in the province and the annual participation fee for such annual revenues between C\$1 million and \$3 million is C\$6,650.

### **Content requirements for offering memorandum**

In certain local jurisdictions, there is a prospectus exemption that is based on the provision of an offering memorandum that contains prescribed disclosure. Most hedge funds, however, would rely on the ‘accredited investor’ prospectus exemption to privately place their securities. There is no requirement that an offering memorandum be provided to the investor in connection with this prospectus exemption. If one is provided, the securities legislation of most local jurisdictions would give the investors in that local jurisdiction a statutory right of action for misrepresentation and require that the offering memorandum include a description of that statutory right. A ‘misrepresentation’ is defined generally as an untrue statement of a material fact or an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made.

### **Restrictions on investments/leverage**

There are no restrictions on the investments that a privately placed hedge

fund can make nor on leverage at the fund level. Investment funds offered by prospectus are often subject to such restrictions, formally under the applicable rules in the case of 'mutual funds' and informally through the policies the securities regulators apply in approving prospectuses in the case of 'non-redeemable investment funds'.

Under NI 31-103, a registered dealer, adviser or investment fund manager is prohibited from lending money, extending credit or providing margin to a client. This is a new requirement that came into force with the new registration regime on 28 September 2009. It does not apply to investment dealers who are IIROC members. This could affect a hedge fund indirectly if it was transacting with a registered firm that was providing the fund with such credit, in connection with a prime broker arrangement for example, and the registered firm was registered in a category that makes it subject to the prohibition.

### **Requirements for local service providers**

There are no express requirements that local service providers be engaged by a hedge fund. If a hedge fund was established in a local jurisdiction it would typically be managed in that local jurisdiction and be considered to receive the investment advice provided by any adviser in that local jurisdiction. The new registration regime in Canada requires that a person acting as investment fund manager be registered as such. The adviser would need to be registered in the province where the fund, through the investment fund manager, received the advice. See the discussion above under the heading 'Registrations/permits/licences required'.

### **Requirements for non-local service providers**

The requirements for non-local service providers would be substantially the same as those for local service providers. In the case of an investment fund manager whose head office is outside Canada, there is a temporary exemption until 27 September 2011 in NI 31-103 exempting such investment fund manager from the investment manager registration requirement. Amendments to NI 31-103 that are expected to be in force in July 2011 will extend this date to 27 September 2012. Non-resident advisers providing investment advice to Canadian hedge funds may have the benefit of the international adviser exemption from the adviser registration requirement. This exemption in NI 31-103 has a number of conditions. For it to be available, the hedge fund would have to be a 'permitted client' for the exemption and, among other things, the adviser would not be permitted to advise in Canada on securities of Canadian issuers, unless providing the advice was incidental to providing advice on a foreign security.

### **Requirements as to directors**

Hedge funds can be organised as different types of entities, not all of which require the appointment of directors. See the discussion below under the heading 'Domiciled fund structures'. For privately placed hedge funds, there are no securities law provisions that would require the appointment

of a board of directors or similar body. Investment funds that are 'reporting issuers' in Canada, by reason of offering securities by prospectus or being listed on an exchange in the local jurisdiction, are subject to NI 81-107. This rule requires that the investment fund have an independent review committee comprised of at least three members all of whom are 'independent'. The responsibilities of the independent review committee are generally to review and make decisions on conflict of interest matters.

### **Ongoing filing/consent requirements**

There are no ongoing filing or consent requirements prescribed by the securities legislation for privately placed hedge funds, although if a hedge fund were a 'mutual fund in the jurisdiction' under the laws of certain local jurisdictions it could be obliged to file its audited annual financial statements and its interim financial statements with the securities regulator if it failed to seek reliance on a generally available exemption from such filing.

For investment funds, including hedge funds that are reporting issuers, there are continuous disclosure requirements under NI 81-106. Material requirements include the requirement to file audited annual financial statements, interim financial statements and annual and interim reports of fund performance with the securities regulators as well as the requirement to send them to security holders; the requirement to post on its website and to send to any security holder on request quarterly portfolio disclosure and a record of its proxy voting record as a security holder; the requirement to file with the securities regulators an annual information form; and the requirement to issue a news release and file within 10 days a report of any material change in the affairs of the investment fund that occurs.

### **Other**

For investment funds, including hedge funds, that are reporting issuers, NI 81-106 sets out requirements for the calculation of net asset value of the fund. For such investment funds that used 'specified derivatives', the net asset value of the fund must be calculated at least once every business day and for such funds that do not use 'specified derivatives', at least once a week. The net asset value of such investment funds must be calculated using the 'fair value' of the investment fund's assets and liabilities. 'Fair value' in this context means the market value based on reported prices and quotations in an active market or, if the market value is not available, or the manager of the investment fund believes that it is unreliable, a value that is fair and reasonable in all the relevant circumstances.

### **1.1.3 Other regimes relevant to hedge funds eg fast track regime for listed funds, private placement regimes, self certification regimes** **Essential requirements to qualify for the regime**

There are no other special or particular regimes in Canada for hedge funds. The private placement regime is discussed above in 1.1.2.

## **1.2 Funds not domiciled in the jurisdiction**

### **1.2.1 Restrictions on/consequences of holding board meetings in the jurisdiction**

There are no restrictions on or consequences of holding board meetings in Canada, although from the tax perspective there could be an issue with whether the fund's mind and management was in Canada such that the fund would be considered to be resident in Canada for tax purposes. This concern may apply as well to meetings of the trustees where the hedge fund is organised as a trust.

### **1.2.2 Licensing requirements if local service providers are appointed**

There would be no licensing requirement for the foreign hedge fund itself if local service providers were appointed.

### **1.2.3 Ability to market fund interests in the jurisdiction**

There is no restriction in Canada on the ability of foreign hedge funds to market their securities to Canadian investors. Like funds organised under the laws of a Canadian province or territory, the securities of the foreign hedge fund would need to be offered in accordance with Canadian laws on the distribution of securities and the requirement that a dealer selling the securities of the hedge fund to Canadian investors be registered or have the benefit of an exemption from the dealer registration requirement. There is an international dealer exemption in NI 31-103 for foreign registered dealers that, where all the conditions are met, would permit them to sell foreign securities in Canada on a private placement basis to 'permitted clients'.

In connection with the coming into force of the new registration regime in Canada, the CSA has confirmed that the 'look through' analysis on the adviser registration question, which used to be applied in the Province of Ontario, is not being continued. The effect of the look through analysis was that the investment adviser of a foreign fund, the securities of which were sold to investors in Ontario, was considered to be providing investment advice to the investors in the fund in Ontario and required to register there as an adviser or identify an exemption from the adviser registration requirement on which it could rely. Certain adviser registration exemptions previously available in the Province of Ontario, such as that for foreign funds offered primarily abroad and offered in Ontario by private placement only, are not being carried forward as a consequence.

The new registration regime in Canada includes a requirement that an investment fund manager register as such. Until 27 September 2011, NI 31-103 exempts a person or company whose head office is not located in Canada from the requirement to register as an investment fund manager. Amendments to NI 31-103 that are expected to be in force in July 2011 will extend this date to 27 September 2012. The CSA issued for comment in October 2010 proposals regarding when an investment fund manager with a head office outside Canada would be required to register as an investment fund manager. The comment period closed in January 2011

and the CSA has not provided information on the proposals' status. Under the October 2010 proposals, in general terms, an investment fund manager with a head office outside of Canada would be required to register in Canada if there were Canadian investors in its funds unless it met one of two exemptions. The first exemption would require that the Canadian investors were all 'permitted clients' and the investment fund manager did not have a 'significant presence' in Canada. It would be considered to have a significant presence in Canada if it acts as investment fund manager for an investment fund that has more than 10% of the fair value of all of the fund's assets attributable to Canadian investors, or where the fair value of all the assets of all investment funds managed by the investment fund manager that is attributable to Canadian investors is more than C\$50 million. Under the second exemption the investment fund manager would not be required to register if neither it nor any investment fund it manages has 'actively solicited' investors in Canada after 28 September 2011, although some CSA members requested comments on whether the 'significant presence' test should also apply to the second exemption proposed.

## **2. TAXATION**

### **2.1 Taxation of the fund**

#### **2.1.1 Funds domiciled in the jurisdiction**

The tax treatment of a fund in Canada is primarily determined by its characterisation as a partnership, corporation or trust. Several of the specific tax differences between the taxation of these vehicles are discussed in more detail below.

#### **2.1.2 Funds managed and controlled in the jurisdiction**

From a Canadian income tax perspective, there is an issue as to whether investment advisory and management services provided by a Canadian adviser to a non-resident client would cause the non-resident client to be considered to be carrying on business in Canada for Canadian tax purposes. A non-resident that is considered to be carrying on business in Canada would generally be subject to Canadian tax on its income from such business, unless an applicable treaty exemption applies. Such a non-resident could also be subject to Canadian tax filing obligations.

There is a safe harbour provision in section 115.2 of the Income Tax Act (Canada) (the Canadian Tax Act) that aims to protect the international competitiveness of Canadian investment services providers. The safe harbour provision will generally apply where a 'Canadian service provider' provides 'designated investment services' to a non-resident with respect to 'qualified investments'. If the provision applies, the services provided by the Canadian adviser will not cause the non-resident to be considered to be carrying on business in Canada. If section 115.2 does not apply, it is a question of fact as to whether services provided to a non-resident would result in the non-resident being considered to carry on business in Canada.

## **2.2 Taxation of investors not resident in the jurisdiction**

### **2.2.1 EU Savings Tax Directive**

Canada is not a signatory to the European Union Savings Tax Directive.

### **2.2.2 Other withholding tax/tax disclosure requirements**

Interest paid by a resident of Canada to a non-resident is subject to a 25 per cent withholding tax (subject to reduction under an applicable tax treaty) only if the Canadian payer and non-resident recipient do not deal at arm's length for the purposes of the Canadian Tax Act, or the interest is 'participating debt interest.'

Interest will not be a 'participating debt interest' for the purposes of the Canadian Tax Act provided that no portion of such interest, other than interest payable on a prescribed obligation (as described below), is contingent or dependent upon the use of or production from property in Canada or is computed by reference to revenue, profit, cash flow, commodity price or any other similar criterion or by reference to dividends paid or payable to shareholders of any class of shares of the capital stock of a corporation. A prescribed obligation for this purpose is, generally, a debt obligation the terms or conditions of which provide for an adjustment to an amount payable in respect of the obligation for a period during which the obligation was outstanding that is determined by reference to a change in the purchasing power of money on which no amount payable in respect of it is contingent or dependent upon the use of or production from property in Canada or is computed by reference to revenue, profit, cash flow, commodity price or any other similar criterion, other than a change in the purchasing power of money, or by reference to dividends paid or payable to shareholders of any class of shares.

Dividends paid by a resident of Canada to a non-resident are subject to a 25 per cent withholding tax (subject to reduction under an applicable tax treaty). Mutual fund trusts and mutual fund corporations can generally make 'return of capital' distributions that are not subject to withholding tax. Rather, these distributions reduce the adjusted cost base of the relevant mutual fund trust units or mutual fund corporation shares.

A disposition of an investment in a Canadian hedge fund will generally not be subject to Canadian tax unless the investment is 'taxable Canadian property' for the purposes of the Canadian Tax Act.

Units of a mutual fund trust and shares of a mutual fund corporation will generally not be taxable Canadian property for a non-resident investor provided the non-resident investor (together with all non-arm's length persons) did not own more than 25 per cent of the shares of any particular class of the trust or corporation within the previous five years and less than 50 per cent of the fair market value of the shares was derived from Canadian real estate or immovable property and/or certain Canadian resource properties.

Units of a partnership will generally be taxable Canadian property at any time where at any time within the previous five years more than half of the fair market value of the partnership's property was attributable to real

or immovable property situated in Canada or certain Canadian resource properties or an income interest in a trust resident in Canada.

### **2.3 Taxation of investors resident in the jurisdiction**

Interest income is fully taxable as ordinary income. Dividends received from taxable Canadian corporations are subject to a gross-up and dividend tax credit mechanism, which effectively serves to integrate corporate and shareholder-level tax. Capital gains are effectively taxed at half the rate of ordinary income.

Canadian investors in foreign hedge funds are subject to the full rates of tax on any income earned from the investment and are not entitled to the dividend gross-up and tax credit mechanisms available in respect of dividends from taxable Canadian corporations. Canadian tax credits may be available to offset foreign withholding taxes on dividends received by a Canadian investor.

There are a number of rules currently in the Canadian Tax Act that impute income to a Canadian investor in a foreign entity. Certain passive income (called 'foreign accrual property income' or FAPI) of a 'controlled foreign affiliate' is imputed to a Canadian investor. The requisite levels of Canadian control often preclude these rules from applying in the hedge fund context. In addition, income may be imputed to a Canadian investor at a designated rate of return on 'offshore investment fund property.' These are generally passive portfolio investments. In order for this provision to apply, it must be reasonable to conclude that 'one of the main reasons' for the Canadian investor's acquiring, holding, or having an interest in the non-resident entity is, in essence, to reduce the taxes that would otherwise have been payable had the income from the underlying portfolio investments been earned directly.

As well, generally, the rules pertaining to 'offshore investment fund property' as defined in the Canadian Tax Act, will apply to a Canadian investor in a foreign hedge fund. Generally, the rules may require such an investor to include an amount in income in each taxation year based on the cost of the fund's offshore investment fund property multiplied by a prescribed interest rate. These rules would apply in a taxation year to such an investor, if it could reasonably be concluded, having regard to all the circumstances, that one of the main reasons for acquiring, holding or having such interest in the fund, was to benefit from the portfolio investments of the fund in such a manner that the taxes on the income, profits and gains therefrom for any particular year were significantly less than the tax that would have been applicable if such income, profits and gains had been earned directly by the investor. Credit is given under these rules for income actually received so that double tax is generally avoided.

There are proposed amendments to the Canadian Tax Act that would significantly change the taxation of Canadians investing in foreign hedge funds.

Under Canada's proposed non-resident trust (NRT) rules, where there are Canadian investors in a non-resident trust other than an 'exempt foreign

trust,' the non-resident trust would be deemed resident in Canada and subject to Canadian tax. There are certain look-through rules that apply to indirect investments in an NRT. A Canadian investor would become jointly and severally liable with the non-resident trust for its Canadian tax obligations. While commercial investment trusts are purportedly intended to fall within the 'exempt foreign trust' exception, it is practically difficult to qualify. For this reason, many Canadian investors are reluctant to invest in non-resident trusts. Recent draft legislation has been released for public comment which seeks to address this concern.

### **3. DOMICILED FUND STRUCTURES**

There are several important considerations when choosing the appropriate hedge fund structure in Canada. These are generally affected by the types of investments the fund is seeking to make and the types of investors the fund is seeking to attract.

#### **3.1 Corporates, including cell/segregated portfolio type structures**

Corporations are taxed as separate legal entities in Canada. While a dividend gross-up and tax credit mechanism provides some integration of corporate and shareholder level taxes for individual Canadian shareholders, corporations are generally not an efficient vehicle for the flow-through of ordinary income.

A mutual fund corporation is tax-efficient with respect to taxable dividends earned on shares of taxable Canadian corporations because it is able to deduct those dividends from its income and receive a refund of tax that it pays on those dividends upon paying taxable dividends out to its shareholders. A mutual fund corporation is also an efficient conduit with respect to capital gains since it is able to receive a refund of capital gains taxes paid by virtue of redemptions of its shares or by paying capital gains dividends out to its shareholders. Capital gains dividends are taxed as capital gains in the hands of shareholders. Accordingly, mutual fund corporations typically pay out sufficient taxable dividends and capital gains dividends to recover all taxes paid.

For income such as interest, foreign investment income and income from certain derivatives, there is double tax when a mutual fund corporation is used. Such income is subject to tax in the mutual fund corporation, which results in a reduction of the amount of that income that is available to be paid out to shareholders as dividends and/or a reduction in the value of the shares that can be realised on redemption.

To qualify as a mutual fund corporation, a corporation must meet the following conditions: it must be a Canadian corporation; it must have shares that are redeemable at the demand of the holder and such shares must represent at least 95 per cent of the fair market value of all of the corporation's issued shares; its only undertaking must be the investing of its funds in property; and it must be a public corporation.

Unlike mutual fund trusts, mutual fund corporations can employ a split-share structure, with each class of shares tracking a different portfolio

of assets. Tax is calculated at the corporate level and so, losses from one portfolio will affect the calculation of another portfolio's income. Tax-deferred switches between classes are available.

### **3.2 Unit trusts**

While trusts are not legal entities in Canada, they are generally taxed at the highest marginal rate for individuals. A deduction is available in respect of income paid or payable to beneficiaries, making trusts generally efficient flow-through vehicles for investment income.

To qualify as a mutual fund trust, a trust must meet the following conditions: it must be resident in Canada; it must be a unit trust and therefore either its units must be redeemable or it must comply with certain investment restrictions; its only undertaking must be the investing of its funds in property; and it must comply with certain prescribed conditions relating to the number of its unit holders, the dispersal of ownership of its units, and the public trading of its units.

Provided a mutual fund trust makes distributions in each year of its net income and net realised capital gains, the mutual fund trust will generally not be liable in such year for Canadian income tax. To the extent that the trust may deduct expenses or losses, it may choose not to allocate all of its income to its beneficiaries. Losses cannot be allocated to unit holders.

Provided certain conditions are met, a mutual fund trust may designate a portion of its foreign source income in respect of a unit holder so that such income and a portion of the foreign tax paid by the fund may be regarded as foreign source income of, and foreign tax paid by, the unit holder for the purposes of the foreign tax credit provisions of the Canadian Tax Act.

The Canadian Tax Act effectively treats 'non-portfolio income' of a specified investment flow-through (SIFT) trust or partnership as if the income had been earned through a taxable Canadian corporation. Tax is imposed at the trust or partnership level at the corporate tax rates and investors are deemed to have received dividends from taxable Canadian corporations. Income that is subject to this tax is generally income from carrying on a business in Canada, Canadian real or immovable properties or investments in subject entities in excess of certain thresholds. While these rules were introduced to stop Canada's income trust market, and from a policy perspective should not apply to hedge fund investments, the rules are broadly drafted and the Canadian tax authorities have provided little guidance on their application.

### **3.3 Limited partnerships**

A partnership itself is generally not liable for income tax nor is it required to file income tax returns, except for annual information returns, which are commonly filed by the general partner. As noted above, a SIFT partnership is effectively taxed as a corporation on its 'non-portfolio income.' A partnership must compute its income (or loss) under the Canadian Tax Act for each of its fiscal periods as if it were a separate person resident in Canada.

Subject to the 'at-risk' rules discussed below, each partner of a partnership

will be required to include (or be entitled to deduct), when computing the partner's Canadian income for a taxation year, the partner's *pro rata* share of the income (or loss) of the partnership allocated to them for the fiscal period of the partnership ending in or at the end of the partner's taxation year. The partner's share of the partnership income (or loss) must be included (or deducted) in computing the partner's Canadian income whether or not any distributions have been made to the partner by the partnership.

The Canadian Tax Act contains 'at-risk' rules that may, in certain circumstances, limit the amount of deductions that a limited partner may claim in respect of a partnership to the amount the partner has put at-risk. Generally, such losses which cannot be deducted in the year because they exceed the limited partner's 'at-risk amount' can be carried forward and deducted in subsequent years to the extent of the partner's 'at-risk amount' in such subsequent years.

Subject to any adjustments required by the Canadian Tax Act, a limited partner's tax cost (called the 'adjusted cost base') of a unit of a partnership will generally consist of the purchase price paid for the unit, increased by any share of income allocated to the limited partner (including a *pro rata* share of the full amount of any capital gains realised by the partnership) and reduced by any share of losses (including a *pro rata* share of the full amount of any capital losses realised by the partnership) and the amount of any distributions made to the limited partner. To the extent the adjusted cost base of a limited partner's units were to be negative, the amount of any negative adjusted cost base will be deemed to be a capital gain of a limited partner in the year in which the adjusted cost base becomes a negative amount. The adjusted cost base of the partnership interest will be increased by the amount of the deemed capital gain.

### 3.4 Linked notes

Notes with a return linked to the performance of a reference fund or portfolio can be used to provide Canadian investors with synthetic exposure to a fund or portfolio. Such notes may have some tax advantages over direct investment in certain circumstances.

Income received on a note in excess of the principal amount of the note is taxed as ordinary income. Although not free from doubt, gains or losses on the disposition of linked notes may be taxed as capital gains or capital losses by investors that hold the linked notes as capital property.

The potential for effectively converting accrued income to capital gains by selling linked notes prior to a payment date has led the Canada Revenue Agency to launch a review of certain favourable administrative positions that it has taken with respect to linked notes. Specifically, the Canada Revenue Agency has previously ruled that there will be no deemed accrual of interest on linked notes under Canada's 'prescribed debt obligation' rules until the amount of interest payable in respect of the linked notes becomes determinable.