Structuring Non-Resident-Owned Renewable Energy Projects in Canada

Canada's renewable energy projects involve considerations too often overlooked during the initial structuring. Developers of these projects are frequently non-residents with no other Canadian business operations. These projects invariably incur substantial start-up losses and generally take several years to attain profitability. In some cases, the objective is to develop and sell the project once it reaches commercial operation. In other instances, the objective is to develop, operate and maintain the project for the duration of the power purchase agreement. Failure to consider these aspects from the outset may result in inappropriate structures and otherwise unnecessary reorganizations in the future.

This article describes common structures and offers a solution to their limitations.

Option A: Canadian-Controlled Private Corporations

Advantages

One typical structure is a two-tier arrangement of Canadian subsidiaries. All projects are either owned directly by the second tier subsidiaries or are held in a further third tier. Use of one tier of subsidiaries is sufficient to provide limited liability. The two-tier structure is intended solely to obtain status as a Canadian-controlled private corporation ("CCPC").

A CCPC is any corporation incorporated in Canada that is not controlled by a non-resident of Canada or by a public company. Since there is no requirement that a CCPC be controlled by a resident of Canada, a CCPC can be wholly-owned by non-residents, provided that no single non-resident controls the CCPC. However, In order to catch such situations, the *Income Tax Act* (Canada) deems all shares owned by non-residents to be owned by a single non-resident. By interposing an additional tier of Canadian holding companies under the non-resident owners, this requirement may be met and the application of this rule avoided.

While a CCPC provides various tax benefits, the primary benefit is an 11% reduction of the combined federal and Ontario corporate income tax on the first $500,000.00 of taxable income each year—this represents annual savings of $55,000.00.

Disadvantages

Problems arise, however, when the non-resident decides to sell a project. Non-resident vendors are exempt from Canadian income tax on capital gains realized upon the disposition of private company shares. If, however, multiple projects are held below a single subsidiary and not all are to be sold to the same purchaser at the same time then the Canadian subsidiary, not the non-resident, becomes the vendor. Unlike the non-resident, the Canadian subsidiary would be fully taxable on its capital gain. The distribution of the sale proceeds, *e.g.*, as a dividend, would then be taxed a second time. The same applies if the projects are held in separate subsidiaries beneath the first.

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As well, such structures assume that the subsidiary will hold the projects long enough to be able to apply its losses against future feed-in tariff revenues; else, the tax benefits of CCPC status would be irrelevant. If, however, the objective is to develop and sell rather than hold and operate, the losses arising from development costs would be trapped in the subsidiary. The application of start-up losses is a key point to consider since Canada does not permit tax consolidation. Each Canadian company is taxed separately from every other, notwithstanding that one company might wholly own the other or that each might be wholly owned by a third. A profitable company cannot, therefore, apply the tax losses of another no matter what the relationship of these companies may be. In such circumstances, a corporate restructuring, such as an amalgamation, would be required to match profits and losses.

In order to realize any benefit from the trapped losses, the vendor must negotiate a premium on the purchase price on the basis that the purchaser will be able to apply those losses. Even then, however, a separate company is often used to perform all development activities such that the losses are not in the company to be sold.

Option B: Limited Partnerships

Advantages

Limited partnerships are generally recommended if both loss consolidation and limited liability is required. Loss consolidation is made possible because a partnership is essentially a contractual relationship, not a legal entity. A partnership's profits or losses are calculated at the partnership level and allocated to the partners according to the terms of the partnership agreement. Each partner then reports those profits or losses as if they were earned or incurred by the particular partner directly.

Limited liability arises from registering the partnership under the applicable limited partnership legislation. Such legislation grants limited liability to the limited partners provided that (i) there is a general partner who remains subject to all liabilities incurred by the partnership and (ii) the limited partners do not take part in the management of the business. Since a general partner is incorporated as a matter of course, a limited partnership enjoys the same limited liability as a corporation.

Disadvantages

Any losses flowed through to a limited partner are applied to reduce the cost base of that limited partner's units—unless, of course, the law on this point differs in the partner's home jurisdiction. This has the effect of increasing the capital gain later upon sale. If the object is to develop and sell, the benefit of loss flow through must then be weighed against the consequent increase in capital gains. Option C suggests an alternative to this choice.

It should also be appreciated that the amount of losses that can be deducted by a limited partner are generally restricted to the amount invested by that partner in the limited partnership units. All

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development costs paid by the limited partner must therefore be routed as a capital investment in the partnership. Too often, these costs are invested directly into a separate development company.

If the profits against which losses are to be applied are earned by a non-resident of Canada then that non-resident must be a limited partner. Inclusion of a non-resident partner would, however, disqualify the partnership as a 'Canadian partnership'. The primary consequence is that payments to the partnership for services would be subject to 15% withholding tax if and when the project becomes profitable.

Finally, there is often the risk that the non-resident will from time to time take part in the management of the business, contrary to formal legal structures put in place to avoid such a situation. Such participation would result in the loss of limited liability for that partner. To avoid the above problems, tax advisors generally recommend the incorporation of a Canadian subsidiary to stand in the non-resident's stead. This would, however, prevent the loss consolidation for which the partnership was intended.

Option C: Single-Tier Corporate Structure

Option C is a simplification of Option A. This simpler structure both allows us to: (i) avoid Canadian income tax on the capital gains realized upon a sale; (ii) apply the development expenses to reduce the taxes on that same gain in the vendor's home jurisdiction—subject to the laws of that jurisdiction; (iii) create losses in the subject company; and, (iv) provide limited liability. And, unlike Option B, losses do not increase capital gains.

As stated above, Canadian law does not tax non-residents on the disposition of private company shares (unless at any time in the previous five years more than 50% of the fair market value of the shares derived from Canadian real estate). If, therefore, the objective is to develop a renewable energy project in order to sell it prior to achieving commercial operation, the project should be held in a Canadian corporation. The difference between this scenario and Option A is that each project would be held in a separate company and every company would be owned directly by the non-resident.

Next, if a separate development company is to be used, service agreements would be entered into between that company and each of the project companies. The project companies would be required to pay for the services received, thus ensuring that development expenses would be incurred by the appropriate project company. Losses would thereby be matched to the appropriate asset.

In order for each project company to pay its own expenses, the non-resident would invest the appropriate amounts as share capital. Thus, while the losses would be trapped within the project companies, the non-resident would increase its cost base in its shares. Development expenses that are paid by the non-resident in any event would thereby reduce the amount of the taxable capital gain

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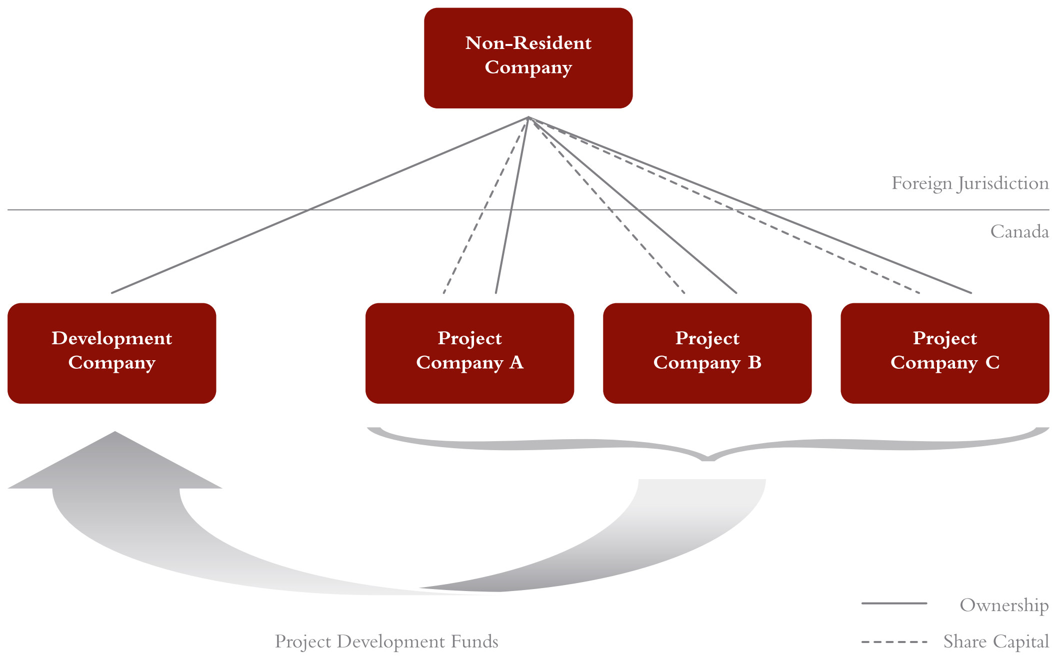
on which the non-resident would generally be taxed in its home jurisdiction. At the same time, the subsidiary would incur losses for which a premium on a sale price may be negotiated while the use of a corporation would provide limited liability.

This structure can be illustrated as follows:



Conclusion

Proper communication of one's ultimate business objectives is essential to ensure that structures generally recommended to Canadian residents are not inappropriately adopted by or on behalf of non-residents. There is no one-size-fits-all and the renewable energy industry, in particular, has its own unique requirements. The objectives must always be understood if unnecessary tax costs or reorganizations are to be avoided.

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