

# Limited Partnerships and Tax Shelters

# Outline

- Commercial issues in limited partnerships
  - Formation
  - Not a legal entity
  - Liability considerations
  - Extra-provincial limited partnerships
  - Participation of limited partners

# Commercial Issues

## Formation of limited partnership

- Can carry on any business that a partnership without limited partners can carry on – LPA ss. 2(1)

# Commercial Issues

## Formation of limited partnership

- Must have one or more general and one or more limited partners

# Commercial Issues

- Formation of limited partnership
  - LP formed when a declaration filed
  - Must there first be a valid partnership?

# Commercial Issues

- Formation of limited partnership
  - LP Declaration expires 5 years after date of filing, or sooner if notice of dissolution filed
  - No dissolution-replacement declaration can be filed

# Commercial Issues

- Formation of limited partnership
  - Not a legal entity

# Commercial Issues

- Liability Issues:
  - No limits on liability of general partner



# Commercial Issues

## Liability Issues:

- Limited partner liable only
  - in respect of the value of money and other property the limited partner contributes, or
  - agrees to contribute
  - as stated in the record of limited partners

# Commercial Issues

- Restrictions on Limited Partners:
  - Cannot have limited partner's name in firm name, or may be liable as a general partner
  - Cannot contribute services – only money and property

# Commercial Issues

- Limited partner must be a passive investor and cannot participate in the control of the business

# Commercial Issues

- What constitutes control on the part of a limited partner?
  - *Haughton Graphics Ltd. v. Zivot and Marshall*
  - *Nordile Holdings Ltd. v. Breckenridge*

# Commercial Issues

- Extra-provincial limited partnerships:
  - Cannot carry on business in Ontario unless it has filed a declaration containing ss. 3(2) info

# Commercial Issues

- Extra-provincial limited partnerships:
  - L/P of extra-provincial partnership not liable if not registered
  - Laws of organizing jurisdiction govern internal affairs and limited liability of partners

# Limited Liability Partnerships

- Recent amendments in Ontario have created “full shield” LLPs
- Problem – partners will have limited liability – so notwithstanding they are active in the business, they will be subject to all the limited partnership rules
- Note 40(3.14) – prevents capital gain when negative ACB arises? (see comfort letter)

# Tax Issues

## Part I

- Determination of Limited Partner
- Limited partnership losses



# Tax Issues

- No definition of either “partnership” or “limited partnership” in ITA
- No definition of “partner” in ITA
- Member of general partnership maybe a limited partner for tax purposes

# Limited Partnership Losses

- Concept – losses deductible by a limited partner in respect of a taxation year cannot exceed the partner’s “at risk amount” at the end of that year
- Such “excess” losses are limited partnership losses

# Who is a Limited Partner?

- Act deems a partner to be a limited partner if:
  - Liability is limited by operation of law
  - Member is entitled to specified benefit
  - Certain agreements relevant
  - 3 year rule

# Timing Issues

- Deduction of losses restricted if member is a limited partner:
  - “at any time in the taxation year”

# Limited Partnership Losses

- Losses which exceed the limited partner's at-risk amount are:
  - Not deductible in computing taxable income for the year; and
  - Not included in computing the limited partner's non-capital losses for the year

# Limited Partnership Losses

- Excess losses of limited partners are:
  - Eligible for indefinite carry-forward
  - Must have future income or future additional capital contributions

# Tax Issues – Part II

- At risk rules
- Tax shelter rules
- Limited recourse debt rules

# The “At-Risk” Problem

- Origins of the problem
  - Debt incurred by partnership to incur expenses or acquire assets (CCA and ITC)
  - Limited partners included in ACB unpaid capital contributions owing to partnership



# The Solution

- Restrictions on allocations of ITC's to limited partners
- Statutory definition of at-risk amounts

# The ITA Regime

- “at risk amount” – ss. 96(2.2)
- “tax shelter” – s. 237.1
- “tax shelter investment” – ss. 143.2(1)
- “limited recourse amount” – ss. 143.2(1)
- “at risk adjustment” – ss. 143.2(2)

# Calculating the At-risk Amount

- Ss. 96(2.2):
  - defines at-risk amount “at any particular time”
  - starting point is A.C.B. – 96(2.2)(a)
  - add share of current year income allocated to partner – 96(2.2)(b)

# Adjustments to At-risk Amount

- Decrease by:
  - Amounts owing by partner to partnership – 96(2.2)(c) (but excluding any 143.2 adjustments)
  - “Amount” or “benefit” to which partner may be entitled – 96(2.2)(d)

# Tax Shelters

# Tax Shelters

- Concept – no deductions allowed in respect of a “Tax Shelter” unless the shelter is registered
- Statute-barred rules N/A
- Originally, registration was virtually automatic
- Now see 4 page application for registration number (form T5001) plus 11 page guide to completing it

# Tax Shelters

- Registration no guarantee CCRA will accept deductions claimed
- Registration is notice to CCRA of what to investigate

# Tax Shelters

- Expansive definition in ss. 237.1(1)
- Not restricted to partnership interests – catches direct investments as well



# Tax Shelters

- Rules applicable when:
  - Losses or amounts “represented to be deductible”
  - equal or exceed cost of the investment, less related prescribed benefits

# Tax Shelters

- Continued

# Tax Shelter Mechanics

- “Promoter” must apply for registration
- Broad definition of “promoter”
- Includes:
  - “advisers” in respect of the sale or issuance, and
  - Anyone who accepts consideration in respect of the tax shelter

# Tax Shelter Mechanics

- Continued

# Tax Shelter Mechanics

- Section 237.1
  - No sales allowed until ID # issued
  - Must provide ID # to each investor
  - Must show ID # on all tax reporting
  - Must display statutory notice

# Tax Shelter Mechanics

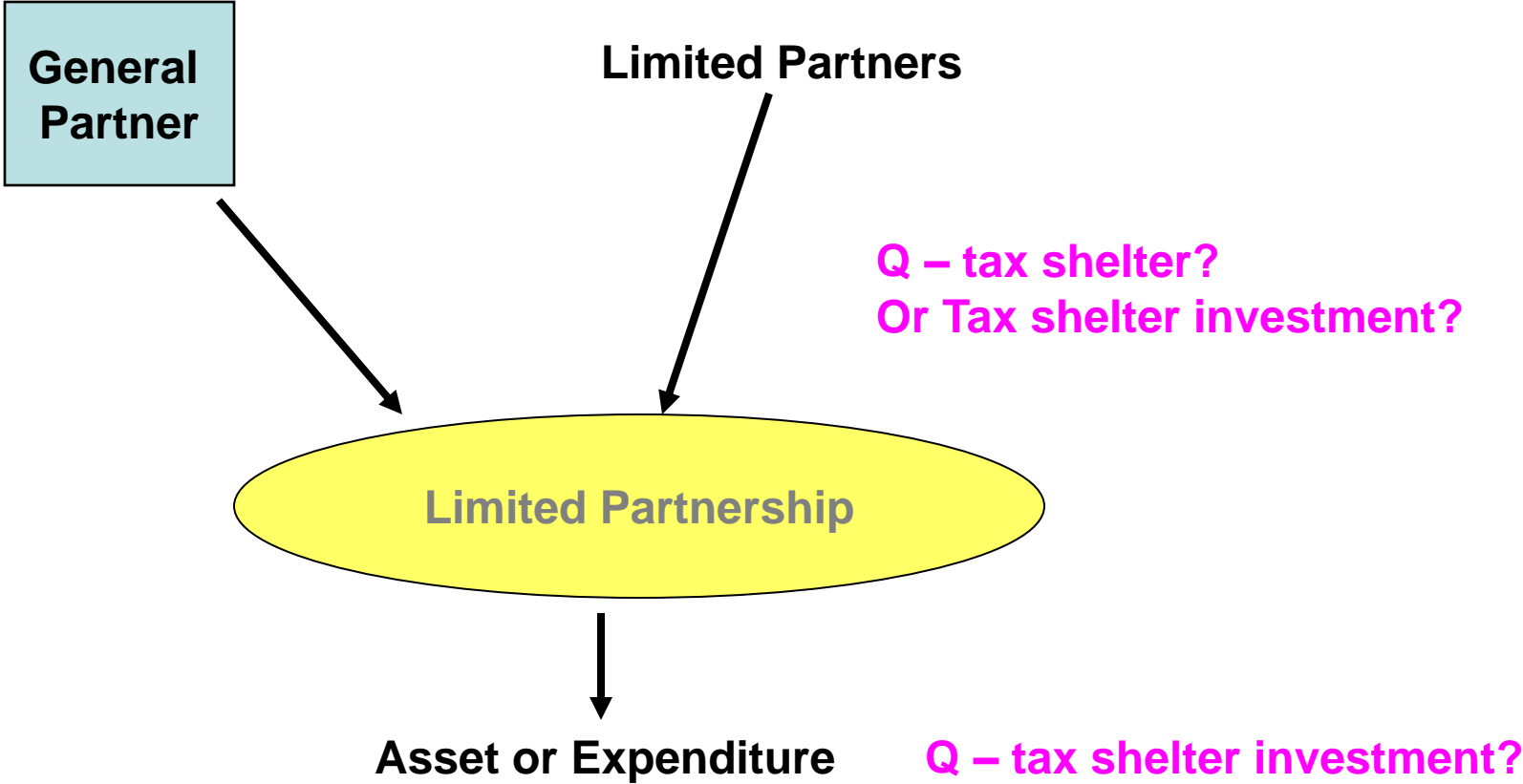
- Annual information return required of Promoter
- Failure to comply
  - penalty of 25% of the consideration received or receivable in respect of the tax shelter

Don't forget the section 163.2 CIVIL PENALTIES

# Tax Shelter Investment

- Multi-part definition in ss. 143.2(1)
- Property that is a tax shelter under 237.1
- Taxpayer's interest in a partnership where
  - an interest in the taxpayer
    - Is a tax shelter investment and
    - The taxpayer's partnership interest would be a tax shelter investment (!!)

# Tax Shelter Investment





# Tax Shelter Investment

- Note that a LP unit can be a “tax shelter” under 237.1
- This would mean that all LPs holding similar units would hold tax shelter investments under para (a) of TSI definition
- But if the LP units are not generically tax shelters, one individual LP might hold his/her unit as a TSI under (b)

# Tax Shelter Investment

- If LP unit is not generically a TSI, how could it become TSI in the hands of a particular LP?
  - Statements or representations made to that particular LP
  - Limited recourse financing of that LPs interest

# Consequences of TSI status

- If the interest of any investor is a tax shelter investment, then the interests of all other investors become TSI also – see subpara. (b)(ii) of definition of TSI

# Indirect TSI

- Consider situation where partnership units are not themselves “tax shelters” under 237.1
- However, partnership acquires property or incurs an expense with a “limited recourse debt” per 143.2(7)
- Limited recourse amount becomes a “prescribed benefit” under Reg. 231(6.1)
- So underlying asset or expenditure becomes a tax shelter under 237.1

# Consequences??

- If the ultimate investment/expense is a TSI, then intention behind legislation was that any intermediate investment would also become a TSI
- Not clear how subpara. (b)(i) accomplishes this

# Tax Shelter Cost Reduction

Cost of property/amount of expenditure reduced by:

- All “limited-recourse amounts” of the taxpayer reasonably related to the expenditure, plus
- The taxpayer’s “at-risk adjustment” in respect of the expenditure

# Limited Recourse Amount

- 143.2(1) definition – recourse for any unpaid principal amount is limited, either immediately or in the future, either absolutely or contingently

# Limited Recourse Amounts

- 143.2(7) extends definition to include unpaid principal amounts unless
  - Bona fide arrangements made at time debt arose for repayment of principal and interest “within a reasonable period not exceeding 10 years” and
  - Interest paid annually  $\geq$  prescribed rate at time debt incurred



# Limited Recourse Amount

- 143.2(8) further extends definition – unpaid amount of debt deemed to be LRA where the taxpayer is a partnership and recourse against any member of the partnership in respect of the debt is limited
- So any debt of a limited partnership becomes a limited recourse debt (including bank operating lines, mortgages, lines of credit, accounts payable)

# Limited Recourse Amounts

- Unpaid principal of limited recourse debt
- Any debt of a limited partnership
- Debt repayable in more than 10 years
- Compound interest debt
- Debt with balloon interest payments
- Debt with no fixed payment terms – eg. inter-corporate accounts

# Consequences of LRA

- Cost of property or amount of expenditure reduced under 143.2(6)
- If the units of the LP are tax shelters in their own right, any expenditure of the LP incurred with debt is reduced by the amount of the LRA
- So unless LP pays cash up front to its suppliers, it can't recognize the expense!!!

# At-Risk Adjustment

- any amount or benefit
- taxpayer may receive or obtain
- at any time
- to reduce any loss in respect of the expenditure or property

# Examples of Unexpected Effects

- Inter-corporate debt
- Line of credit
- Employee share purchase plan with downside protection
- Long term financing of revenue producing asset

# Planning with Limited Partnerships

- Any “at risk” adjustments under 96(2.2)?
- Any “tax shelter” issues under 237.1?
- Any “limited recourse adjustments” under 143.2?

# Tax Shelter Opinions

- Check the scope of the opinion – what assumptions have been made? Have the critical issues been assumed away?
- Have the facts been independently verified, or is opinion based strictly on information presented by promoter? How?
- Does opinion reflect the transactions described in the securities offering document?
- Reality check = does OM reflect every transaction in the series?