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

General Partner

Limited Partners

Limited Partnership

Asset or Expenditure

Q – tax shelter? Or Tax shelter investment?

Q – 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?