Rotfleisch & Samulovitch

Limited Partnership Losses and the At-Risk Amount

Legal Forms for Canadian Businesses – Limited Partnership Losses and the At-risk Amount

The Canadian legal environment provides businesses with a number of different choices for legal forms to structure themselves, most prominently corporations, sole proprietorships, partnerships and limited partnerships. These forms have different legal and tax aspects associated with them. Limited partnerships are a useful business form with significant tax advantages and liability advantages, but also some unexpected aspects which can trip up unwary taxpayers. This article briefly summarizes the tax aspects of limited partnerships in the Canadian legal landscape and describes limited partnership losses and the at-risk amount can create problems our experienced Toronto tax lawyers help our clients avoid.

Sole Proprietorships

If an individual begins carrying on a business by themselves without setting up different legal form for the business, then the individual will be operating a sole proprietorship. In this legal form, there is no concept of a business entity separate from the individual. The individual will be fully liable for all liabilities incurred in the course of carrying on business. The individual will need to report the profits of the business as his or her own business income on his or her income tax return and is also able to claim the losses of the business as his or her own.

Corporations

Corporations are the most familiar business form for most Canadians. Corporations are treated as a separate legal person from their shareholders (i.e. the persons who own a corporation). One consequence of this is that except in special circumstances creditors of a corporation can only access the assets of the corporation and not the assets of its shareholders. From a Canadian income tax perspective, corporations are treated as independent taxpayers responsible for paying tax on their own income separate from their shareholders.

Partnerships

A partnership is a relationship which exists between a group of persons carrying on a business together with a view to profit. The partners are personally liable for the debts of the partnership. Canadian income tax law does not treat partnerships as taxpayers liable to pay tax on the income generated by the business of the partnership. Instead, every partnership has a fiscal period (usually one year in length). The income or loss earned by the partnership during that fiscal period is allocated to its partners in proportion to their ownership of the partnership as laid out in the partnership agreement. Each partner then includes their portion of the income or loss from the partnership in their tax year in which the partnership's fiscal period ends. Note that this income or loss allocation can be, and often is, different and separate from any cash flow allocations. This income tax feature of partnerships can be very useful for businesses which are expected to operate at a loss for an extended period of time before becoming profitable as this allows the partners to shelter their income from other sources using the partnership's losses.

Limited Partnerships

A limited partnership is a type of partnership that includes at least one general partner and at least one limited partner. A general partner is any partner who is not a limited partner. General partners operate as described in the preceding section. A limited partner is not permitted to take an active role in running the partnership's business but is also not liable to creditors of the partnership other than for the limited partner's investment into the limited partnership. This business form is useful when the partnership tax treatment is desirable and some investors in the business will provide funding but not be involved in operating the business. In most circumstances limited partners receive the same tax treatment as general partners, however as described below, there are some circumstances in which the tax losses a limited partner receives from the limited partnership are subject to limitations.

Limited Partnership Losses – Limited Partnership Losses and the At-risk Amount

The Canadian Income Tax legislation covering limited partnerships is designed to prevent limited partners from claiming losses in excess of the money that they have put "at-risk" by virtue of their investment in the limited partnership. The concept guiding these rules is that since limited partners have limited liability, they are only risking the amount of money that they paid for their limited partnership interests. General partners by contrast do not have limited liability protection, and so can actually end up losing more than they invested in the partnership, which is why they are not subject to a similar restriction. For a passive investor, this is one of the main downsides of investing as a limited partner instead of as a general partner.

When a limited partner is allocated the share of the limited partnership's losses for a fiscal period, the partner needs to calculate the portion of those losses, if any, which are limited partnership losses. However, CRA has taken the position that limited partnership losses can not be claimed after the limited partnership winds up. When the limited partner prepares a tax return for the year in which the relevant fiscal period of the limited partnership ends, the limited partner can only claim a deduction in that year for the portion of these losses that are not limited partnership losses.

A limited partner's limited partnership losses for a fiscal period is the portion of the limited partner's loss allocation that exceeds a threshold amount. If the loss allocation is below that threshold amount, then the limited partner has no limited partnership losses for the year. The threshold amount is the amount by which:

- the limited partner's at-risk amount

exceeds the sum of

- the amount of in respect of the limited partnership to be added in calculating the limited partner's investment tax credit for the limited partner's taxation year,
- the limited partner's share of any losses of the limited partnership for the fiscal period from a farming business, and
- the limited partner's share of the following expenses incurred by the limited partnership for the fiscal period:
    - foreign resource pool expenses,
    - Canadian exploration expenses,
    - Canadian development expenses, and
    - Canadian oil and gas property expenses.

The limited partner's at-risk amount is supposed to capture in general how much room is left for the partner to be able to deduct losses before the limited partner would be claiming losses in excess of what the limited partner paid for the limited partner interest. The different amounts subtracted off from the at-risk amount are to make corrections for various special cases where certain types of expenses or losses are subject to different rules and so not worked into the general definition. Similarly, the rules are designed not to let limited partners use a combination of losses and tax credits for limited partners arising from the activities of the limited partnership to gain a tax benefit in excess of the cost of the limited partnership interest.

Limited partnership losses can be carried forward indefinitely and used to claim deductions in a limited partner's future tax years but cannot be carried backwards and be applied to past tax years. However, limited partnership losses carried forward can only be applied to a particular taxation year of a limited partner to the extent that:

- the limited partner's at-risk amount in respect of the limited partnership at the end of the limited partnership's last fiscal period ending in the particular taxation year

exceeds the sum of

- the amount of in respect of the limited partnership to be added in calculating the limited partner's investment tax credit for the limited partner's taxation year,
- the limited partner's share of any losses of the limited partnership for that fiscal period from a business or property, and
- the limited partner's share of the following expenses incurred by the limited partnership for that fiscal period:
    - foreign resource pool expenses,
    - Canadian exploration expenses,
    - Canadian development expenses, and
    - Canadian oil and gas property expenses.

The Limited Partner At-Risk Amount – Limited Partnership Losses and the At-risk Amount

The *Income Tax Act*'s provides detailed rules for calculating a limited partner's at-risk amount. The structure of these rules puts the limited partner's adjusted cost base for the limited partnership at the core of determining the limited partner's at-risk amount. The idea behind this is that as limited partners only stand to lose what they have put into the partnership due to limited liability, the adjusted cost base amount which tracks the cost of the limited partnership interest to the limited partner is a closely related idea. The rules for calculating the at-risk amount then also provide for certain amounts to be added to or subtracted from the adjusted cost base to correct for ways that adjusted cost base over or understates what the limited partner stands to lose if the business of the partnership were to collapse.

Adjusted Cost Base

The starting point for calculating a taxpayer's adjusted cost base for a partnership interest is how much it cost the taxpayer to acquire the interest in the partnership. This could be the amount invested in the partnership or the cost of purchasing a partnership interest from an existing partner. The taxpayer's adjusted cost base may also be subject to a variety of upward or downward adjustments applicable to specific circumstances.

A taxpayer's adjusted cost base of an interest in a partnership is subject to the following specific adjustments by virtue of being an interest in a partnership:

- upwards by the amount of the taxpayer's share of the partnership's profits for each fiscal period of the partnership,

- upwards by the amount of any capital contribution made by the taxpayer to the partnership (not including loans to the partnership),
- downwards by the amount of the taxpayer's share of the partnership's losses for each fiscal period of the partnership, and
- downwards by each distribution of the amount of the taxpayer's share of the partnership's profits or capital.

These adjustments are necessary to prevent either double taxation (i.e. where partnership profits are taxed both as business income and as a capital gain) or non-taxation of partnership profits. These adjustments also help the adjusted cost base track how much a limited partner has "at-risk". Partnership profits and additional capital contributions by the limited partner both increase how much value the limited partner has in the partnership which is exposed to possible future losses. Similarly, partnership losses and withdrawals of capital from the partnership reduce how much value the limited partner has tied up in the limited partnership that could be lost in the future if the partnership's business fails.

When a limited partnership interest was acquired from a transferor other than the partnership, a special deeming rule applies for determining the adjusted cost base of the limited partnership interest for the purposes of computing the limited partner's at-risk amount. When such a transfer occurs, the limited partner's adjusted cost base is deemed to be the lesser of the adjusted cost base as otherwise determined and the adjusted cost base of the transferor of the limited partnership interest immediately before it was transferred.

In addition, if the cost base of the transferor is negative, it is treated as being nil instead. After the transfer, the new owner of the limited partnership interest will still be subject to the normal adjustments to the adjusted cost base of their limited partnership interest as described above as they arise.

If the transferor's adjusted cost base cannot be determined, it will be treated as being equal to the total of the downward adjustments discussed below for the transferee as determined at the time immediately after the transaction.

Adjustment for the end of the Partnership Fiscal Period

If the time at which a limited partner's at-risk is to be calculated is the end of the partnership's fiscal period, then at-risk amount will be adjusted for the limited partner's share of the partnership's income for that fiscal period. A similar adjustment is made for Canadian exploration expenses, Canadian development expense, and Canadian oil and gas property expenses if applicable to the fiscal period. This is often the most relevant time for considering a limited partner's at-risk amount since it is also the time when it is determined whether there were any limited partnership losses for the fiscal period or whether previous limited partnership losses can be carried forward. The adjustment is necessary because at this time, the adjusted cost base adjustments for the fiscal period have not yet been applied.

Other Amounts that Reduce the At-risk Amount

A limited partner's at-risk amount is reduced by the total of all amounts owed by the limited partner to the partnership or to a person or partnership which is not at arm's length from the partnership. An exception to this adjustment applies when the amount owing is already included in the cost to the limited partner of the partnership interest.

A limited partner's at-risk amount is also reduced by any amount or benefit that the limited partner or a person not dealing at arm's length with the limited partner is entitled to that was granted for the purpose of reducing the impact of any loss the limited partner sustain by virtue of being a limited partner or by disposing of an interest in the limited partnership. The following amounts are exceptions to the foregoing adjustment rule:

- amounts or benefits included in the determination of the value of J in the definition of “cumulative Canadian exploration expense” within the *Income Tax Act*,
- amounts or benefits included in the determination of the value of M in the definition of “cumulative Canadian development expense” within the *Income Tax Act*,
- amounts or benefits included in the determination of the value of I in the definition of “cumulative Canadian oil and gas property expense” within the *Income Tax Act*,
- entitlements from a contract of an insurance made with an insurance corporation dealing at arm’s length with each member of the limited partnership under which the limited partner is insured against any claim arising as a result of a liability incurred in the ordinary course of carrying on the partnership business,
- entitlements arising as a consequence of the death of the limited partner,
- entitlements arising in respect of an amount not included in the at-risk amount of the taxpayer determined without taking into account the foregoing adjustment rule, and
- entitlements arising because of an excluded obligation (as defined in the *Income Tax Regulations*) in relation to a share issued to the limited partnership by a corporation.

Pro Tax Tips – Limited Partnership Losses and the At-risk Amount

The at-risk amount based restriction on using losses from a limited partnership can result in a significant reduction on return on investment in a limited partnership for investors. The rules regarding the at-risk amount are highly complex, so advice from an experienced Canadian tax lawyer is necessary when setting structuring an investment involving a limited partnership.

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