# CHAPTER 16

# LIMITED PARTNERSHIPS AND JOINT VENTURES

## Review Questions

1. A limited partnership consists of two general classes of partners. Identify these classes, and describe the rights and obligations of each.

2. What can be done by a general partner to limit the extent of its obligations to the limited partnership?

3. "The tax treatment of limited partnership income and losses depends on the tax position of each partner." Explain.

4. What key factors distinguish the limited partnership from the standard partnership?

5. "A limited partnership provides broader access to sources of capital." Is this statement true? Explain.

6. Why is there less risk for the passive investor when a business venture is organized as a limited partnership, rather than a corporation?

7. Why is it that the passive investor in a profitable business venture may receive a higher rate of return if the venture is organized as a limited partnership, rather than a corporation?

8. What is a joint venture, and how is it different from a partnership?

9. With respect to the following, how does the tax treatment applied to a joint venture differ from that for a partnership?

   (a) Determination of capital cost allowance.

   (b) Active business income eligible for the small-business deduction.

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## Solutions to Review Questions

R16-1. The two classes of partners required in a limited partnership structure are general partners and limited partners. The general partner is fully liable for the obligations of the partnership entity (i.e., beyond its proportionate ownership ratio) and is also responsible for managing its business affairs. Limited partners, on the other hand, are responsible for the partnership obligations only to the extent of their investment in the partnership entity (similar to the limited liability aspect of a shareholder in a corporation). In addition, to qualify as a limited partner, the investor must not take part in the management and control of the partnership business. By definition, limited partners are passive investors. [ITA 96(2.4), 96(2.2)]

R16-2. An investor who intends to be a general partner (and, therefore, is exposed to full risk) can limit the extent of its financial risk by creating a separate corporation with a limited amount of capital to act as the general partner. As the corporation has limited capital (i.e., the amount required for investment in the partnership) and is itself a limited liability entity, it can only suffer losses to the extent of its net worth, even though it is liable for all of the partnership's obligations.

R16-3. Similar to the standard partnership, the limited partnership is not a taxable entity. Instead, its net income or loss is allocated, for tax purposes, to the general and limited partners in accordance with their profit sharing ratios. The income or loss allocated retains its source and characteristic and is included in the partners' income calculation in its original form. The tax treatment of the income allocated is thus dependent on the nature of each partner (i.e., whether they are individuals or corporations). For example, dividends allocated to an individual partner are subject to a gross-up and dividend tax credit, but if allocated to a corporate partner, it would be treated as an intercorporate dividend excluded from taxable income (but perhaps subject to a Part IV tax).

R16-4. The factors that distinguish a limited partnership from a standard partnership are as follows: [ITA 96(2.4)]

- Some partners in a limited partnership have limited liability. In a standard partnership each partner is fully exposed to the entity's obligations.
- Limited partnerships must have some partners who are not active in management (i.e., are passive investors). The standard partnership does not have this requirement.
- In a limited partnership, the losses allocated to the limited partners can only be used by them to a maximum of their "at risk" amount. In a standard partnership, all losses allocated are available for partner use.

R16-5. Yes, the statement is true when made in comparison to a standard partnership. In a standard partnership, the unlimited liability feature tends to discourage the participation of investors who are not active in management. In particular, it discourages the interest of a large number of small passive investors from investing a small amount for a minor partnership interest because the risk of unlimited liability is too high.

However, in a limited partnership, the requirement that limited partners be passive investors in exchange for limited liability permits the partnership base to be divided into a large number of small units. A small investor can, therefore, participate with a limited amount of risk. This is similar to a corporation issuing shares to a number of smaller investors except that the limited partnership has the added advantage of being able to allocate its losses to the limited partners to create tax savings for them personally.

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R16-6. As a passive investor, an investment in a corporation or a limited partnership has limited liability. Therefore, the amount that the investor can lose in each structure is finite and in this sense each structure presents equal risk. However, the tax savings that can result from suffering a loss in each structure is different. An investment loss from corporate shares results in a capital loss of which only 1/2 is allowed for tax purposes at the time the shares are disposed. In a limited partnership, the passive investor can usually deduct the full amount of the loss, and the loss is recognized annually as the partnership allocates business losses to the partners. For example, a taxpayer in a 50% tax bracket who lost $10,000 in a share investment would suffer an after-tax loss of $7,500 ($10,000 - 50% [1/2 of $10,000]), but in a limited partnership investment would lose only $5,000 ($10,000 - 50% of $10,000). Therefore, the downside risk of a limited partnership structure is less for the passive investor than in a corporate structure.

R16-7. A passive investor in a profitable venture that is organized as a corporation distributes its profits as dividends. When the passive investor is an individual, the dividend is taxable and, therefore, two levels of tax occur (corporate and personal). Where the corporation is a public company or a CCPC earning income in excess of the small business deduction limit, some double taxation will occur. For example, from $1,000 of venture profits the investor may receive a return of $474 as follows:

| | |
|---|---|
| Corporate income | $1,000 |
| Tax @ 27% | (270) |
| Dividend distribution – Eligible | 730 |
| Tax @ 35% | (256) |
| Net to investor | $ 474 |

However, under a limited partnership structure, the venture income is taxed only once at the partner level. Therefore, $1,000 of venture profits may provide an after-tax return to the investor of $500 ($1,000 - personal tax @ 50%). Because the limited partnership can avoid double taxation for individual partners, greater after-tax returns can be achieved.

R16-8. A joint venture is an association of two or more entities for a given limited purpose without the usual powers and responsibilities of a partnership. The primary feature that distinguishes a joint venture from a partnership is the concept of limited purpose. A partnership usually represents an ongoing business relationship whereas the joint venture is formed for the purpose of completing a single transaction or activity of a limited duration.

R16-9. In a partnership, the amount of capital cost allowance must be established by the partnership and each partner is subject to that determination. In a joint venture, title to property remains in the hands of the participants and, therefore, each participant can claim all or a portion of the CCA permitted annually. This same treatment applies to other types of discretionary items for tax purposes (e.g., reserves).

Active business income earned by a partnership is subject to a notional small business deduction limit of $500,000 which must be shared by the corporate partners in their profit sharing ratios. In a joint venture structure, no such limit applies. For example, if a joint venture earns $700,000 of active business income, a 50% corporate joint venture participant (CCPC) would be entitled to apply the small business deduction on its full share of joint venture profits ($350,000) provided that it has not already used its limit from its own other business activities.

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## Key Concept Questions

### QUESTION ONE

On March 1 of the current year, Mathew Munoz acquired a 1% interest in a partnership that carries on a nursing home business in several provinces in Canada. Mathew paid $10,000 for the partnership interest. The partnership reported a loss for the current year. Mathew was allocated a business loss of $16,000 from the partnership.

Describe the tax implications of the loss for Mathew under the following two assumptions:

1) Mathew has a limited partnership interest.
2) Mathew has a general partnership interest.

*Income Tax Act reference: ITA 96(2.1), 111(1)(e).*

### QUESTION TWO

Hasan Giles owns a 5% interest in a limited partnership. The adjusted cost base of his partnership interest at the beginning of the current year was $40,000. For the current year Hasan was allocated $8,000 of capital gains and $22,000 of business income from the partnership. At the end of the current year, Hasan had a loan from the partnership in the amount of $12,000.

Determine Hasan's at-risk amount at the end of the current year.

*Income Tax Act reference: ITA 96(2.2).*

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## Solutions to Key Concept Questions

### KC 16-1

[*ITA 96(2.1); 111(1)(e)* – Limited partnership – at-risk rules]

1) If Mathew has a limited partnership interest then Mathew can claim the loss only to the extent of his investment in the partnership, $10,000, being the amount *at-risk* of being lost if the business venture of the partnership fails. The excess limited partnership loss, $6,000, can be carried forward indefinitely and can only be claimed to the extent of the at-risk amount from that same partnership. There is no carry back of limited partnership losses. The at-risk rules do not apply to capital losses or farm losses incurred by the partnership.

2) If Mathew has a general partnership interest then the entire $16,000 loss is deductible against his other sources of income for the current year.

### KC 16-2

[ITA 96(2.2) – Limited partnership – at-risk amount]

The at-risk amount is calculated at the end of a partnership's fiscal period as follows:

| | | |
|---|---|---|
| ACB of the partnership interest (beginning of year) | | $40,000 |
| Share of income for the current year: | | |
| Capital gains | $ 8,000 | |
| Business income | 22,000 | 30,000 |
| Balance of loan received from the partnership | | (12,000) |
| At-risk amount (end of current year) | | $58,000 |

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