BUDGET 2018: A BLAST FROM THE PAST – TIERED-PARTNERSHIP TRAP REINSTATED

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Budget 2018 proposes to tighten the so-called "at-risk" rules in the *Income Tax Act* (Canada) (the "**Tax Act**") to limit the losses that may flow through a tiered limited partnership structure. The proposed amendments have been introduced to overrule recent case law, and to bring the law into line with the administrative practices of the Canada Revenue Agency (the "**CRA**") that prevailed prior to 2016.

Background

The "At-Risk" Rules

The "at-risk" rules effectively restrict the losses allocated by a partnership to a limited partner that may be deducted by the limited partner in computing its taxable income. The Tax Act generally provides that a limited partner may not deduct losses allocated to it by a limited partnership to the extent that the losses exceed the amount that the limited partner has invested in the partnership.

Losses allocated by a limited partnership that may not be deducted by virtue of the "at-risk" rules are generally characterized as "limited partnership losses", which may subsequently be applied by the limited partner to offset income that is allocated by the particular limited partnership in the future.

However, difficulties arise in applying the "at-risk" rules to a limited partner that is, itself, a partnership (an "**Upper-Tier Partnership**"). The CRA historically took the position that losses of a limited partnership (a "**Lower-Tier Partnership**") that were allocated to an Upper-Tier Partnership, but could not be deducted because the losses exceeded the Upper-Tier Partnership's "at-risk" amount in respect of the Lower-Tier Partnership, were also precluded from being able to be carried forward as a "limited partnership loss" and applied to offset income in future years.[1] The CRA's position was predicated on the notion that, under Canadian law, partnerships are not separate juridical entities, but simply relationships that subsist between two or more persons carrying on business in common. The Tax Act recognizes the unique character of a partnership and does not generally treat a partnership as a separate taxpayer. The section of the Tax Act that governs the future application of limited partnership losses (paragraph 111(1)(e) of the Tax Act) provides that only a "taxpayer" may deduct limited partnership losses. Accordingly, in the CRA's view, because an Upper-Tier

Partnership is not a "taxpayer" for the purposes of section 111 of the Tax Act, neither an Upper-Tier Partnership, nor its partners, are permitted to utilize limited partnership losses in the future.

Recent jurisprudence overruled the CRA's long-standing administrative position on the application of the "at-risk" rules to Upper-Tier Partnerships. In *Green v.The Queen*,[2] the Tax Court of Canada concluded that the "at-risk" rules do not preclude a loss allocated by a Lower-Tier Partnership from being deducted when computing the income of the Upper-Tier Partnership. The Court undertook a textual, contextual and purposive analysis of the "at-risk" rules to conclude that Parliament did not intend for the "at-risk" rules to permanently preclude an Upper-Tier Partnership (and its partners) from being able to avail themselves of the benefit of a limited partnership loss in future taxation years. The Federal Court of Appeal subsequently upheld the judgment of the Tax Court of Canada.

In contesting the taxpayer's appeal in *Green*, the Government asserted that if an Upper-Tier Partnership was permitted to deduct partnership losses that exceeded its "at-risk" amount in respect of the Lower-Tier Partnership, the "at-risk" rules could effectively be circumvented. In this regard, the Government expressed particular concern that taxpayers could form an Upper-Tier Partnership to hold limited partnership interests in several Lower-Tier Partnerships, and thereafter use the losses allocated from one Lower-Tier Partnership to offset income allocated from another Lower-Tier Partnership without regard to the amount "at risk" in any of the Lower-Tier Partnerships. The Government further argued that the "at-risk" rules could be circumvented entirely if one were to establish a general partnership to serve as the limited partner of a Lower-Tier Partnership.

Notwithstanding the potential validity of the foregoing concerns, the Federal Court of Appeal expressly concluded that such possibilities did not outweigh the negative ramifications of interpreting the "at-risk" rules in the manner advocated by the Government. The Federal Court of Appeal instead held that Parliament could amend the Tax Act if it felt that changes were warranted.

Accepting the Court's Invitation

In Budget 2018, the Government responded to the Federal Court of Appeal's invitation in Green by proposing amendments that will effectively preclude an Upper-Tier Partnership (or its partners) from ever being able to utilize losses allocated by a Lower-Tier Partnership that exceed the Upper-Tier Partnership's relevant "at-risk" amount. Under the proposed amendments, a loss precluded by the "at-risk" rules from being deducted in computing the income of an Upper-Tier Partnership will effectively be deemed never to have been incurred by the Upper-Tier Partnership. Correspondingly, the proposed amendments confirm that the adjusted cost base of the Upper-Tier Partnership's interest in the Lower-Tier Partnership will not be reduced by the amount of the denied loss. The Government asserted in Budget 2018 that the purported adjustment to the computation of

the adjusted cost base of interests in Lower-Tier Partnerships will have the effect of reducing any capital gain arising on a subsequent disposition of interests in such Lower-Tier Partnerships (or increasing the loss that would be triggered on such dispositions), thereby yielding an appropriate result from a tax policy perspective. However, despite the Government's assertions, the proposed amendments do not address the timing difference between being able to apply a limited partnership loss against future income allocated by a Lower-Tier Partnership and utilizing a loss that may only arise on the ultimate disposition of interests in the Lower-Tier Partnership. Similarly, the proposed amendments fail to recognize the practical reality that non-capital losses allocated from a Lower-Tier Partnership may generally be applied against all forms of income of an Upper-Tier Partnership in contrast to the capital losses that would arise on a disposition of an interest in a Lower-Tier Partnership, which may only be applied to offset capital gains incurred by an Upper-Tier Partnership.

The proposed amendments also have a retrospective element. Under the proposed amendments, any non-capital loss or limited partnership loss of a partner of an Upper-Tier Partnership attributable to prior allocations from a Lower-Tier Partnership will effectively be reversed to accord with the proposed amendments. In effect, the proposed amendments will reinstate the Government's historical administrative position vis-à-vis the application of the "at-risk" rules in the context of tiered partnership structures. However, the retrospective element of the proposed amendments will not affect the prior application of losses in respect of taxation years that ended prior to February 27, 2018.

The proposed amendments will re-establish a trap inherent in the "at-risk" rules as they apply to tiered-partnership structures. While the proposed amendments address certain of the concerns raised by the Government in Green, the amendments extend further and effectively penalize partners of Upper-Tier Partnerships that would, in the absence of the Upper-Tier Partnership, have been permitted to apply limited partnership losses arising from allocations from a Lower-Tier Partnership against future income allocated by the Lower-Tier Partnership.

Investors in tiered-partnership structures would be well advised to review the projected income and cash flow positions of all Lower-Tier Partnerships and take steps, including deferring any discretionary deductions, so as to minimize the allocation of losses through the structure that may be permanently denied under the proposed amendments.

The proposed amendments will apply, when enacted, to taxation years of a partner that end on or after February 27, 2018.

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[1] See, for example, CRA Document No. 2004-0107981E5 (25 February 2005).[ps2id id='1' target='/]
[2] 2016 DTC 1018 (TCC), aff'd 2017 DTC 5068 (FCA) ("Green").[ps2id id='2' target='/]

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.