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# Canadian Federal Income Tax Considerations: Applicable in Respect of "Secondary" Transactions

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This article summarizes the principal Canadian federal income tax considerations generally applicable in respect of a “secondary” sale of an interest in a limited partnership (LP Interest). A secondary sale is considered to be a sale by a limited partner of its LP Interests, to another or new limited partner, in contrast to an issuance of an LP Interest by a limited partnership (an LP).

As a preliminary matter, the applicable LP Agreement must be reviewed to address various tax-related matters such as income allocation provisions, and the conditions of transferability of the LP Interests, as there may be restrictions relating to the tax status of the purchaser, such as requiring the purchaser to be a resident of Canada for purposes of the Income Tax Act (Canada) (the ITA). It is very important to identify multi-jurisdictional considerations as early as possible. These would include determining the jurisdiction(s) in which the seller or purchaser may have tax filing obligations or potential tax liability.

**Seller Tax Considerations**

A seller will generally realize a capital gain (or capital loss) equal to the amount by which the proceeds of disposition exceed the Canadian tax cost of the LP Interest, plus reasonable costs of disposition. The Canadian tax cost will require a computation commencing with the original cost to acquire the LP Interest and various ongoing additions or deductions. Partnership income (or loss) will be allocated to the former limited partner for the fiscal year in which the taxpayer ceases to be a member. The income (or loss) allocated will increase (or decrease) the tax cost of the LP Interest.

The seller should ascertain the Canadian tax status of the purchaser of the LP Interest as soon as possible, and obtain tax advice whether special rules in subsection 100(1) of the ITA could apply to increase the taxable capital gain. In summary, this can occur if the LP Interest was sold to a certain type of person, and certain other tests are satisfied. These rules are very broad and should be carefully reviewed in order to identify any potential unanticipated tax consequences.

If the seller is a non-resident of Canada for purposes of the ITA, and the LP Interest is “taxable Canadian property,” the seller must comply with certain tax clearance requirements, tax return filing requirements, and potential tax liability subject to whether the gain is protected from Canadian tax under a tax treaty.

**Purchaser Tax Considerations**

If the prospective purchaser of the LP Interest is a non-resident of Canada for purposes of the ITA, it must be determined whether (a) it is permitted by the LP Agreement to purchase the LP Interest directly, (b) if so, whether it will be subject to ongoing Canadian tax compliance obligations, or (c) whether it should use a Canadian corporation to acquire the LP Interest. There will be many additional Canadian tax considerations if a Canadian subsidiary is used, such as how it is financed.

A prospective purchaser who is subject to tax in Canada in respect of its share of future gains realized by the LP will wish to investigate whether there is any inherent gain in property of the LP at the time of acquisition. Generally, the tax cost of any partnership property will not be written up to fair market value at the time of the secondary transaction. Consequently, if the property is sold by the LP in the future, the purchaser may be allocated some gain that was inherent at the time they became a partner.

Another due diligence consideration for the purchaser is to investigate how the income of the LP will be allocated to it for the year of a purchase and how this relates to cash distributed. The purchaser will want to be aware of whether there will be an “inappropriate” amount of income allocated to it.

Another consideration that can arise with respect to the LP Interest, in certain instances, is where the “at risk” rules in the ITA apply. These rules can limit the amount of a loss that can be deducted by a limited partner from a business. These rules, in effect, restrict the amount of the loss to not exceed the taxpayer’s “at risk amount” at the end of the relevant fiscal year. The at risk amount in respect of a LP Interest includes the Canadian tax cost of the LP Interest to the purchaser, computed in accordance with a very specific rule relevant to secondary acquisitions. Where a taxpayer has acquired the LP Interest at any time from a transferor, other than the partnership, there is a deeming rule that in effect will deem the at-risk amount of the purchaser to be nil (subject to exceptions) unless the Canadian tax cost of the seller can be determined by the purchaser.

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