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RRSP Eligibility and Tax Consequences of Small Business Investment Limited Partnerships ("SBILPs")

This article provides an insight into the RRSP eligibility of limited partnership interests or units, as we see that more and more entrepreneurs are considering this type of vehicle for attracting seed financing and start-up capital. I will first provide a general overview of the special limited partnership RRSP eligibility requirements under the Regulations to the *Income Tax Act* (Canada). These definitions under the Regulations, which some are defined below, may be somewhat lengthy, however, a clear understanding of these terms are required for a complete understanding of the SBILP rules. Next, I will discuss some of the tax consequences of acquiring and disposing of qualified investments in limited partnership units or interests. Finally, I will discuss how a SBILP should be structured for raising capital so that it qualifies as an RRSP eligible investment.

General Overview

Regulation 4900(6) states that a "*qualified investment*" for a trust governed by an RRSP, RESP and a RRIF is possible if an interest of the limited partner (i.e. investor) is a limited partnership interest or unit in a "*small business investment limited partnership*" ("SBILP").

A SBILP is defined under Regulation 5102(1) as follows:

A partnership is a small business investment limited partnership if at all times after it was formed and before that time:

- (a) it had only one general partner;
- (b) the share of the general partner, as general partner, in any income of the partnership from any source in any place, for any period, was the same as his share, as general partner, in:
 - (i) the income of the partnership from that source in any other place;
 - (ii) the income of the partnership from any other source;
 - (iii) the loss of the partnership from any source;
 - (iv) any capital gain of the partnership; and
 - (v) any capital loss of the partnership;for that period, except that the share of the general partner, as general partner, in the income or loss of the partnership from specified properties may differ from his share, as general partner, in the income or loss of the partnership from other sources;

- (c) the share of the general partner, as general partner, in any income or loss of the partnership for any period was not less than its share, as general partner, in the income or loss of the partnership for any preceding period;
- (d) the interests of the limited partners were described by reference to "units" of the limited partnership that were identical in all respects;
- (e) no limited partner or group of limited partners who did not deal with each other at arm's length held more than 30 per cent of the entire units of the limited partnership and, for the purposes of this paragraph:
 - (i) a small business investment corporation that has not borrowed money and in which the shareholder or group of shareholders who did not deal with each other at arm's length held more than 30 per cent of the outstanding shares of any class of voting stock, shall be deemed not to be a limited partner; and
 - (ii) the general partner shall be deemed not to hold any unit of the partnership as a limited partner;
- (f) its only undertaking was the investing of its funds and its investments consisted solely of:
 - (i) *small business securities* where, except as provided in Regulation 5104(1), the partnership was the first person (other than a broker or dealer in securities) to have acquired the securities and it has owned the securities continuously since they were so acquired;
 - (ii) property (other than *small business securities*) described in any of subparagraphs (f)(i) to (iv) of the definition "*qualified limited partnership*" in Regulation 5000(7);
 - (iii) specified properties; or
 - (iv) any combination of properties described in any of subsections (i) to (iii) above;
- (g) it has complied with Regulation 5102(2);
- (h) it has not borrowed money except for the purpose of earning income from its investments and the amount of any such borrowings at any time did not exceed 20 per cent of the partnership capital at that time; and
- (i) it has not accepted deposits.

A "*small business security*" is a share of the capital stock of an *eligible corporation* having full voting rights under all circumstances as defined in Regulation 5104(1).

An "*eligible corporation*" is defined in Regulation 5100(1) as a particular corporation that is a taxable Canadian corporation or all or substantially all of the Canadian property which is at that time used in a "*qualifying active business*" carried on by the particular corporation.

A *qualifying active business* is defined in Regulation 5100(1) as a business carried on primarily in Canada by a corporation but does not include a business, the principal purpose of which is to derive income from property (including interest, dividends, rent and royalties) or a business of deriving gains from the disposition of property (other than a property in the inventory of the business) and at least 50% of the full time employees of the corporation and all corporations related thereto employed in respect of the business are employed in Canada or at least 50% of the salaries and wages paid to employees of the corporation and all corporations related thereto employed in respect of the business are reasonably attributable to services rendered in Canada.

In summary, the following additional assumptions must be made for the limited partnership to qualify as a SBILP:

- (a) the investor must be an individual (not including a trust, unless the trust is governed by a RRSP);
- (b) the investor must be a resident or citizen of Canada;
- (c) the investor must deal at arm's length with the eligible corporation, the partnership and with all other investors;
- (d) based on representations of the general partner and the limited partnership, all costs incurred or to be incurred by the partnership and the eligible corporations are and will be reasonable in the circumstances;
- (e) the investor must hold its units as capital property. An investor will hold its units as capital property if none of its operating motivations in acquiring the units are to sell them at a profit;
- (f) no investor or group of investors has since the limited partnership formation had ownership of more than 30% of the units of the limited partnership;
- (g) no investor will own, directly or through any entity or related person, more than 10% of any class of shares of the general partner or, if more than 10% of such class is owned, then the cost base of such shares will be less than \$25,000.00; and
- (h) based on representations of the general partner, at any time any units are contributed to or held by an RRSP, less than 10% of the partnership's assets, measured by fair market value, will be represented by non-business assets.

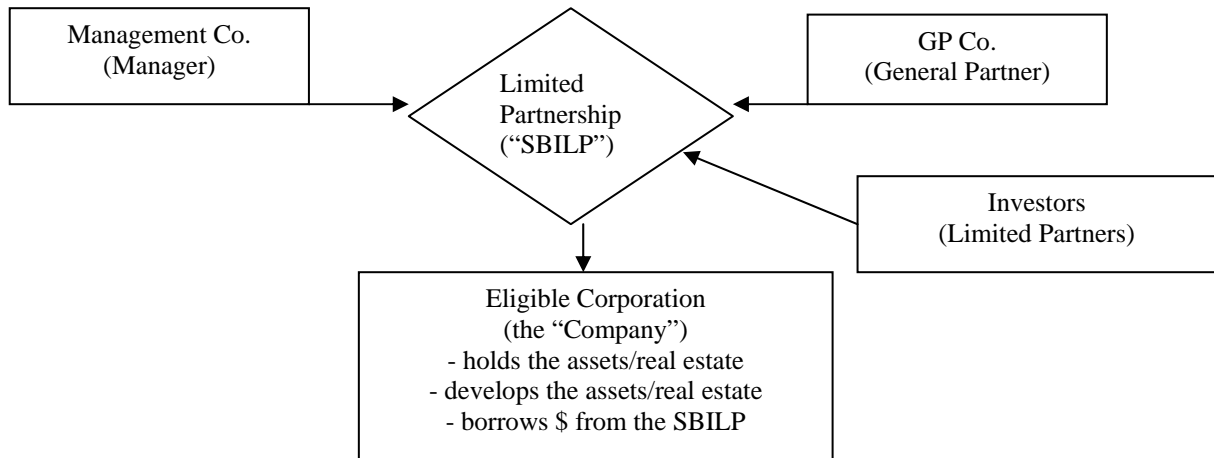
Units as a "qualified investment" for an RRSP

A unit or interest in a SBILP is a qualified investment for an RRSP. A SBILP is a limited partnership that has no activities other than the lending of money to or the acquisition of shares of an eligible corporation.

An "*eligible corporation*" at any time is a taxable Canadian corporation wherein at least 90% of the assets of which are used at that time in a qualifying active business. Canada Revenue Agency ("CRA") has issued conflicting opinions on whether the 90% test is based on the original cost of assets to the corporation or the fair market value of the assets. CRA's position is that a corporation which owns cash which is to be invested in a qualifying active business is not an eligible corporation until at least 90% of the cash is actually invested. A "*qualifying active business*" as described above, is any business carried on primarily in Canada other than a business of earning passive investment income or capital gains from the sale of property.

Hence, if the eligible corporation as described in Figure 1 below has an active business of deriving gains from its business, (say for example land development), then the limited partnership will qualify as a SBILP.

Figure 1:



There will be no tax consequences to an annuitant under an RRSP on the disposition by the RRSP of a unit, provided the consideration received is at least equal to the fair market value of the unit at the time of disposition. Any gain derived by the RRSP on such a disposition will be taxed as described in the section entitled, "Maturity of an RRSP" below. There will be no tax consequences to an RRSP or the annuitant thereunder if the shares of the eligible corporation owned by the limited partnership are disposed of by the limited partnership.

An investor who holds units outside of an RRSP and who disposes of a unit, either by sale, gift, redemption, transfer or on a deemed disposition at death, will realize a capital gain or incur a capital loss, equal to the amount by which the proceeds of disposition of the unit exceeds the adjusted cost base of the unit.

The adjusted cost base of a unit generally will be the difference between (i) the aggregate of the original cost of the unit (not including amounts paid out of or owing as limited recourse financing), additional capital contributions made to the date of disposition, and the amount of any net income or capital gains allocated to the investor by the limited partnership for fiscal periods ending prior to the date of disposition, and (ii) the aggregate of any business or capital losses allocated for fiscal periods of the limited partnership ending prior to the date of disposition and any withdrawals of cash or property prior to the date of disposition.

The adjusted cost base of a unit may become negative at any time. An investor must recognize a capital gain equal to the amount by which the adjusted cost base is less than zero at the end of the limited partnership's fiscal year.

An investor must include one-half (50%) of the amount of any capital gain in income and will be entitled to deduct one-half (50%) of any loss against only capital gains realized from other properties.

Investors will be deemed, subject to certain rules, to have disposed of their units on the winding up of the limited partnership. If in the course of winding up, the limited partnership disposes of property to an investor who was, immediately before the wind up, a member of the limited partnership, then the limited partnership will be deemed to have disposed of the property for proceeds equal to its fair market value at that time and the investor will be deemed to have acquired the property for an amount equal to that fair market value. In this case the limited partnership may have income from the disposition which may be allocated to the investors.

Where the limited partnership winds-up and certain conditions are met, the limited partnership will be deemed to have disposed of its property to the investors for proceeds equal to the investors' pro rata portion of the cost amount of the property to the limited partnership and the investors will be deemed to have acquired the property for an amount equal to that fair market value. Accordingly, no immediate tax consequences will arise to the limited partnership solely by virtue of the disposition of the property by the limited partnership to the investors. However, the investors may have a capital gain if the cost of the property to the limited partnership exceeds the investor's adjusted cost bases of its units.

Transfer of Units to a Second RRSP

There will be no tax consequences on the transfer of units from an RRSP of which an individual is the annuitant to a similar RRSP or a RRIF. If the terms of the RRIF provide that the annuitant's spouse will become entitled to payments from the RRIF on the annuitant's death, there may be transfer restrictions with respect to the units on the annuitant's death.

A payment from an RRIF to the annuitant or his/her spouse may not exceed the value of all property held by the RRIF, including units, immediately before the payment. As an aside, certain individuals who are not married are nevertheless deemed to be spouses for purposes of the *Income Tax Act* (Canada).

Maturity of an RRSP

On the maturity of an RRSP (which, must occur on or before the date the annuitant attains 69 years of age) the annuitant may choose (1) to receive as income the full value of the property in the RRSP and pay tax thereon; (2) to receive the types of annuities which qualify as retirement income and pay tax on the annuity payments when received; or (3) to use the property in the RRSP to establish an RRIF. If an annuitant dies the value of the remaining annuity payments, in the case of a matured plan, and the amount to which the deceased is entitled, in the case of an unmatured plan, will be included in the deceased's income in the year of death unless the amounts pass by reason of a designation in the RRSP to a spouse or to certain prescribed children or grandchildren.

If an RRSP distributes the units to an investor, the investor will be taxed as discussed above for investors who hold units outside an RRSP. The cost base of the distributed units to the investor will be the fair market value of the units at the time the units are distributed.

Tax Consequences to the eligible corporation (the "Company")

Acquiring the Properties

The SBILP, as described in Figure 1, is commonly used for land acquisition banking and development purposes. There is no immediate income tax consequence to the Company solely by reason of acquiring the land/properties. The Company may be required to pay tax under and provincial property tax regimes (i.e. if in B.C., under the "*Property Transfer Tax Act*") on the acquisition of the properties. The Company will be entitled to add this tax to the cost of the properties for purposes of the *Income Tax Act* (Canada). Where the Company buys and sells serviced lots without constructing housing on the lots, the Company will be required to register for GST in respect of such sales and will be entitled to recover all GST paid in the course of such activities. The same will be true where the Company constructs new housing on a lot and sells such new housing. If the Company buys and sells used housing the Company

will not be entitled to charge GST on such housing and will not be entitled to recover GST expended in the course of such activities.

Holding the Properties

Interest Payable

Interest on money borrowed by the Company to acquire properties (including interest payable to the limited partnership) will not be currently deductible and will be added to the cost of the properties for tax purposes. In effect such interest will be deducted when the properties are sold.

Capital Cost Allowance

The Company will not be entitled to deduct capital cost allowance on the properties in computing its income for any year because such properties will be deemed inventory.

Management Fees

During the time the Company holds the properties it may pay management fees to the Manager, pursuant to a management services agreement. The Company will have to pay 7% GST on all management fees. The Company may have to pay GST on various other goods and services acquired in the course of its business and may be entitled to recover GST paid in the course of its business. The Company may be entitled to deduct the GST paid for income tax purposes or to add the GST to the cost of the properties, depending on the nature of the good or service in respect of which the GST was paid.

Disposing of the Properties

When the Company disposes of a property it will realize a gain (or loss) and must include (may deduct) 100% of the profit (loss) in (from) its income. The gain (loss) will be calculated as the difference between the sale price of the property plus all costs associated with the sale less the inventory cost of the property.

If the properties are inventory to the Company then in computing its income for a taxation year the Company is entitled to value the properties at the lower of cost and fair market value. The lower of cost and value rule will not apply to real property which is the subject of "an adventure in the nature of trade". If property is valued at the lower of cost and value in one year (so that a deduction results in that year) and there is a subsequent increase in value, the property must be valued at the lower of cost and current value. This may result in taxable income to the Company without any cash to pay the tax. However, in most cases the Company will be entitled to carry-forward the deduction from the previous year and offset it against the income included in the subsequent year.

Inventory

Certain of the tax consequences to the investors, the limited partnership and the Company, as described above depend on whether the properties are capital property or inventory to the Company. In most cases of land banking or land syndication and development ventures, the properties will be deemed inventory to the Company.

General Anti-Avoidance Rule

The *Income Tax Act* (Canada) contains a general anti-avoidance rule ("GAAR") which allows CRA to recharacterize any transaction if it is an avoidance transaction. An avoidance transaction is a transaction designed to achieve a tax benefit. CRA has published its position on the application of GAAR to certain fact situations. CRA's position is that financing a limited partnership with capital borrowed by the partners will not be subject to GAAR even if this reduces the interest which the limited partnership otherwise would have capitalized.

Tax Shelter Identification

Many SBILPs apply for, and obtain a tax shelter identification number in respect of their offering, which is usually by way of an offering memorandum. The *Income Tax Act* (Canada) requires that the following appears on all offering memorandums in relation to tax shelters:

"The identification-number issued for this tax shelter shall be included in any income tax return filed by the investor. Issuance of the identification number is for administrative purposes only and does not in any way confirm the entitlement of an investor to claim any tax benefits associated with the tax shelter."

Conclusion

As discussed at the outset, this article is a mere general overview of the special limited partnership RRSP eligibility rules and requirements under the Regulations to the *Income Tax Act* (Canada). As these rules are quite complex, professional advice obtained through a tax professional is highly recommended when structuring limited partnerships with the view of qualifying as an RRSP eligible investment.

For further inquiries, please contact the writer at gshannon@millerthomson.com or visit www.millerthomson.com for a list of the tax professionals at Miller Thomson LLP.