INVESTING IN INVESTMENT FUNDS: LIMITED PARTNERSHIPS

TAX MATTERS

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INFORMATION FOR INVESTORS

This document relates to funds structured as limited partnerships and is intended only for Canadian residents holding limited partnership units. If you have not yet purchased limited partnership units, you should seek independent tax advice before investing. Limited partnership units are not eligible for registered accounts. Investors in limited partnerships are strongly advised to seek their own independent tax advice regarding their investments. If you have any questions regarding the tax forms, please contact your tax advisor.

Taxes, an important component of your investment portfolio

Understanding how your investments are taxed is an important part of developing an effective investment portfolio. This guide provides general tax information related to the purchase and sale of funds structured as a limited partnership.

What is a Limited Partnership?

A limited partnership ("LP") is a legal structure that can be used for many purposes, including funds that hold a portfolio of investments. A LP must have a general partner ("General Partner") and at least one additional partner in order to exist. Partners other than the General Partner are called limited partners and have limited liability to the extent of their investment in the LP and will be bound by the terms of a limited partnership agreement. The General Partner, on the other hand, has unlimited liability for the obligations of the LP. The General Partner is responsible for day to day operations of the LP and may choose to delegate some or all of these responsibilities to a manager. Throughout this document the term "limited partners" and "investors" are used interchangeably.

An investment fund that is structured as a LP receives money from limited partners who purchase units of the LP and the resulting pool of money is managed by a portfolio manager. The portfolio manager buys and sells securities on behalf of the limited partners. The securities purchased depend on the LP's investment objective and strategies; examples include, but are not limited to, cash, bonds and stocks of particular companies, private and public debt and real estate. These investments may generate income in the form of interest or dividends. In addition, capital gains or losses may be realized when securities held in the LP are sold.

Income tax considerations and consequences

This document discusses the impact of taxation of investment funds structured as LPs held in non-registered accounts. It is important to mention that investments in an LP are not eligible for registered accounts such as TFSAs, RRSPs, RRIFs and RESPs.

When do I pay taxes on my investment in Limited Partnership?

Generally, tax considerations related to your investment in the LP can be grouped into two categories:

- Taxes associated with allocation of income, losses or expenses from the LP.
- Taxes related to the redemption of units of the LP.

ALLOCATION OF INCOME, LOSSES OR EXPENSES FROM THE LIMITED PARTNERSHIP

LPs are flow through entities. A LP itself is not subject to income tax; all of its income and expenses are allocated to its investors for inclusion in their tax returns.

Depending on your personal situation, there may be two tax advantages of LPs compared to other legal structures (such as mutual fund trusts).

1. All income and expense items within a LP retain their tax character and are allocated directly to limited partners. For example, a LP may allocate to its investors eligible Canadian dividends and capital gains, which are both taxed at preferential rates compared to interest income, as well as expenses (such as management fees and operating expenses). Expenses are deductible for income tax purposes against the limited partner's income from all sources (which may be otherwise taxed at the highest marginal rate of income tax).
2. All expenses of a LP and all of its net capital losses, if any, may be allocated to the limited partners who may use them to offset any earned ordinary income or capital gains. Limited partners are not taxed on any distributions received from the LP because all distributions are treated as a return of capital and reduce the adjusted cost base ("ACB") of the investment in the LP; rather they must pay tax on allocations of taxable amounts from the LP. Therefore, taxes may be owed by a limited partner even if they have not received any cash payments from the LP.

Allocation of Income or Loss

Taxable income is allocated to limited partners as outlined in the LP's limited partnership agreement. The characterization of a LP's earnings as capital gains (or losses) or ordinary income (or expenses) will depend on the specific facts and circumstances of the activities of the LP. Your share of any income, capital gain or loss of the LP from any source will be treated as if it were your income, capital gain or loss from that source and must be included in your personal tax return.

It is important to mention that whether or not you receive distributions from the LP, income or capital gain may still be allocated to you. As a result, you may be required to pay tax on such income or capital gain allocation even though you have not received any distributions. Example 1 below illustrates the tax treatment of allocated capital gains for a limited partner:

Example 1 - Allocation of capital gains from the LP without paying cash distributions

Assume at the beginning of year you bought 100 units of the LP at $50 per unit. Your ACB of the units would initially be $5,000 (100 x $50 = $5,000). At the end of the year you were allocated $500 of capital gains from the LP and no cash distributions were paid in the year.

Your total capital gain is $500.

Currently 50% of the capital gain is subject to tax, so the taxable capital gain is:

$500 x 50% = $250

Assuming a marginal tax rate of 53.53%, this would result in taxes payable of $134:

$250 x 53.53% = $134

You have to pay $134 of income taxes even though you haven't received any cash distributions and haven't sold any units of the LP. The allocated capital gains of $500 is added to the ACB of your investment in the LP, so that at the end of the year your ACB would be $5,500 (100 x $50 +$500 = $5,500).

INCOME AND EXPENSES ALLOCATED TO LIMITED PARTNERS

Below is a description of different types of income and expenses that may be allocated to limited partners and how they are taxed:

1. Interest Income

Interest income is earned on investments such as short term notes, bonds and preferred shares. Interest income is fully taxable.

2. Canadian Dividends

Dividend income is earned when the LP invests in shares of Canadian corporations that pay dividends. Investors may be eligible to a dividend tax credit and may be applied towards dividend income from Canadian corporations which may reduce the amount of tax owing on dividend income.

3. Capital Gains

Capital gains occur when an investment within the LP is sold for more than its ACB. Currently, 50% of capital gains are taxable.

4. Foreign Income

Foreign income is earned when the LP receives dividends or interest from non-Canadian investments. Foreign income is fully taxable.

5. Expenses

Expenses include carrying charges and withholding taxes. Carrying charges are expenses that the LP paid to earn income from investments and may include management fees, interest on money borrowed by the LP for investment purposes and operating expenses. Carrying charges and withholding taxes are deductible for income tax purposes against the investor's income from all sources.

Example 2 - Allocation of Interest Income and Carrying Charges from the LP and paying cash distributions

Assume at the beginning of the year you bought 100 units of the LP at $50 per unit. Your ACB of the units would initially be

$5,000 (100 x $50 = $5,000). At the end of the year you were allocated $500 of interest income, $200 of carrying charges and received $100 in cash distributions from the LP.

In general, carrying charges are deductable for income tax purposes against the investor's income from all sources, so the taxable income for the limited partner is $300:

$500 - $200 = $300

Assuming a marginal tax rate of 39.34%, this would result in taxes payable of $118:

$300 x 39.34% = $118

Cash distributions of $100 and $200 of carrying charges will reduce the ACB of your investment in the LP and allocated interest income of $500 is added to the ACB of your investment, so the net effect on the ACB of your investment would be a $200 increase ($5,000 + $500 - $100 - $200 = $5,200).

T5013 TAX YEAR END SLIPS

The different types of income, capital gains, losses and expenses that are allocated to you are reflected on your T5013 tax slip, which is mailed annually to you by March 31 for the preceding calendar year. The T5013 includes amounts you must include in your tax return. The T5013 also includes supplementary amounts that may assist you to calculate the ACB in relation to your investment in a LP.

A sample and instructions on a T5013 tax slip are attached below:

Canada Revenue Agency | Agence du revenu du Canada

Fiscal period-end
Exercice se terminant le
YYYY-MM-DD
AAAA-MM-JJ

T5013
Statement of Partnership Income
État des revenus d'une société de personnes

Filer's name and address – Nom et adresse du déclarant

Tax shelter identification number (see **statement** on back *)
Numéro d'inscription de l'abri fiscal (lisez **l'énoncé** au dos *) **TS**

Partner code / Code de l'associé: 002
Country code / Code du pays: 003
Recipient type / Genre de bénéficiaire: 004

Partnership account number (15 characters) / Numéro de compte de la société de personnes (15 caractères): 001
Total limited partner's business income (loss) / Total du revenu (de la perte) d'entreprise du commanditaire: 010
Total business income (loss) / Total du revenu (de la perte) d'entreprise: 020

Partner's identification number / Numéro d'identification de l'associé: 006
Partner's share (%) of partnership / Part de l'associé (%) dans la société de personnes: 005
Total capital gains (losses) / Total des gains (pertes) en capital: 030
Capital cost allowance / Déduction pour amortissement: 040

Partner's name and address – Nom et adresse de l'associé
Last name (print) – Nom de famille (en lettres moulées) | First name – Prénom | Initials – Initiales

Box – Case	Code	Other information – Autres renseignements

Box –Case	Code	Amount – Montant	Box –Case	Code	Amount – Montant

T5013 (21) **Protected B** when completed – **Protégé B** une fois rempli

See the privacy notice on your return.
Consultez l'avis de confidentialité dans votre déclaration.

BOX 105 LIMITED PARTNER'S AT-RISK AMOUNT: The maximum amount of losses that you may deduct for tax purposes cannot exceed the total at-risk amount (ARA). This amount is used to reconcile reported amounts and is not reported in your tax return.

BOX 106 LIMITED PARTNER'S ADJUSTED AT-RISK AMOUNT: This amount is used to reconcile reported amounts and is not reported in your tax return.

BOX 030 TOTAL CAPITAL GAINS (LOSSES): You are not required to report this amount in your tax return.

BOX 128 INTEREST FROM CANADIAN SOURCES

BOX 132 ACTUAL AMOUNT OF ELIGIBLE DIVIDENDS: This is the actual amount of eligible dividends paid by corporations resident in Canada.

BOX 133 TAXABLE AMOUNT OF ELIGIBLE DIVIDENDS: This is the taxable amount of eligible dividends for partners that are individuals resident in Canada (other than a trust that is a registered charity), including partnerships and trusts that are eligible for the federal dividend tax credit.

BOX 134 DIVIDEND TAX CREDIT FOR ELIGIBLE DIVIDENDS: The dividend tax credit is a non-refundable tax credit which applies when Canadian dividends are included in income.

BOX 135 FOREIGN DIVIDEND AND INTEREST INCOME

BOX 151 CAPITAL GAINS (LOSSES)

BOX 171 FOREIGN TAX PAID ON NON-BUSINESS INCOME: Use this amount to calculate your foreign tax credits on your foreign non-business income.

BOX 210 CARRYING CHARGES: This amount is your share of the carrying charges for earning all investment income.

HOW TO CALCULATE ACB FOR A LIMITED PARTNERSHIP

In general, the ACB is calculated as:

1. The amount paid to acquire your LP interest (including any initial sales commission paid); plus
2. Your share of any income or capital gains of the LP allocated to you; less
3. Your share of capital losses and expenses of the LP allocated to you; less
4. Any distributions made to you from the LP.

The ACB could become a negative amount if the total of the reductions referred to above exceeds the additions. If the ACB of your investment is negative at the end of any fiscal year, you must recognize that negative amount as a capital gain in the current fiscal year (the ACB of your units would then become zero). Currently, only 50% of the capital gains will be taxable.

Example 3 below illustrates ACB calculation for limited partner:

Example 3 - ACB calculation for LPs

Assume at the beginning of Year 1 you bought 100 units of the LP at $50 per unit for an initial ACB of $5,000 (100 x $50 = $5,000). At the end of Year 1, you were allocated $500 of capital loss from the LP and no cash distributions were paid in the year. At the end of Year 2, you were allocated $1,000 of income from the LP and no cash distributions were paid during the year. At the end of Year 3, you were allocated $500 of income from the LP and the LP paid $100 in cash distributions.

Below is the calculation of the ACB in each year:

	Income / loss Allocation	**Distributions paid**	**ACB - End of the Year** (ACB end of previous year + current year contributions – current year redemptions at cost - current year distributions received +/- allocation of income / loss in current year)
Year 0			$5,000 (100 x $50)
Year 1	$500 loss	-	$4,500 ($5,000 - $500)
Year 2	$1,000 income	-	$5,500 ($4,500 + $1,000)
Year 3	$500 income	$100	$5,900 ($5,500 +$500 - $100)

REDEMPTION OF UNITS

A redemption (i.e. sale) of units is a taxable disposition.

If you redeem LP units for more than their ACB, you have realized a capital gain. Realized capital gains must be reported for tax purposes in the year of sale and are generally taxed more favorably than regular income. Currently, only 50% of a capital gain is subject to taxes, whereas 100% of income is subject to tax.

If you redeem LP units for less than their ACB, you have realized a capital loss. Generally, such capital losses can be applied against capital gains when determining net taxable capital gains for a given tax year. If you have no realized capital gains in the year a capital loss is realized, the loss can be carried back and applied against taxable capital gains from any of the previous three years. You are also allowed to carry the loss forward indefinitely to offset capital gains in future years.

If you redeem all or part of LP units during the calendar year, you will receive T5008 slip by March 31st of the following year. A T5008 slip reports the proceeds paid to you for investments you have sold during the tax year. It is important to mention that it is the investors' responsibility to track the ACB of your investment in an LP and report any capital gains or losses realized from the redemption of units of a LP.

The following examples show how capital gains and capital losses are calculated:

Example 4 - Capital gain on disposition of LP units; no allocation of income/expense or capital gain/capital loss

Assume at the beginning of the year you bought 100 units of the LP at $50 per unit. Your ACB of the units would initially be $5,000 (100 x $50 = $5,000). Assume that you sell 100 units at a later date, during the year at a unit price of $60.

Your total capital gain is $1,000:

($60 x 100) – ($50 x 100) = $1,000

Currently, 50% of the capital gain would be subject to tax, so the taxable capital gain is:

$1,000 x 50% = $500

Assuming a marginal tax rate of 53.53%, this would result in taxes payable of $268:

$500 x 53.53% = $268

Example 5 - Capital loss on disposition of LP units; no allocation of income/expense or capital gain/capital loss

Assume at the beginning of the year you bought 100 units of the LP at $50 per unit. Your ACB would initially be $5,000 (100 x $50 = $5,000). Assume that you sell 100 units at a later date during the year at a unit price of $40.
Your total capital loss is $1,000:
($40 x 100) – ($50 x 100) = ($1,000)
This capital loss can be used to offset other capital gains realized in the current year or carry it forward indefinitely or back three years to offset capital gains.

FREQUENTLY ASKED QUESTIONS

What happens if the LP is dissolved? Will there be a balloon payment? How will it be taxed?

Once the LP winds up, the LP will redeem all of the outstanding units held by investors. Any investments held by the LP will be sold and after deduction of any outstanding costs and cost of dissolution, the net proceeds will be used to fund any final redemption payment to investors. The difference between the amount paid to investors at this time and their ACB will be a capital gain or loss, as the case may be, for Canadian income tax purposes.

Are Units of the LP eligible for Registered Plans?

No. Units of LPs do not qualify as an eligible investment for deferred income plans such as RRSPs, RRIFs, DPSPs, RESPs, RDSPs and TFSAs.

Does my investment in the LP constitute reportable Foreign Property? Am I required to file form T1135 for my LP investment?

The LPs do not constitute reportable foreign property as the Canadian limited partners are investing in a Canadian-domiciled LP. Therefore, investors do not need to file form T1135 in respect of these funds.

How will the distributions to investors in the LP be taxed?

Distributions received from a LP are not taxable in and of themselves. However, such payments will decrease the ACB of the units you own. Additionally, each investor will receive a T5013 slip each year which includes your proportionate share of any dividends, income, capital gains or capital losses and carrying charges earned or incurred by the LP. You must include such amounts in your personal tax returns based on instructions included with the T5013 slip.

Will there be tax reporting from the LP to the Limited Partners?

Yes. T5013 tax slips are provided to investors annually by March 31.

I sold my LP units, am I going to receive an ACB calculation from the LP?

No. Limited partners will receive a T5008 tax slip the following year after the year you redeem part or all of your units in the LP. T5008 slip reports the proceeds paid or credited to you for LP units you have sold. It is the responsibility of each limited partner to correctly track their own ACB.

Why doesn't the amount allocated to me on my T5013 slip match to the distributions I received during the year?

Since a LP is a flow-through entity, all of its income, expenses, and net capital gains or losses must be allocated to investors and reported on a T5013 slip. There is no requirement for a LP to make distributions that are equivalent to the amounts allocated – or to make distributions at all – so that is why the amounts may be, and often are, different. Similarly, simply because you have received a distribution payment from a LP does not mean that you have a tax liability. Distributions from LPs are not directly taxable in and of themselves.

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