

Elimination of Tax Deferral — Partnerships and Joint Ventures

Cary Heller, CA, is a Tax Partner in the Toronto office of Collins Barrow.

A partnership held by corporate partners allowed for the deferral of tax where the partnership has a year end that ends shortly after the year end of the corporate partners. Tax could be further deferred by stacking partnerships with staggered year ends. The 2011 federal budget introduced proposals to eliminate the deferral of tax on partnership income allocated to a corporate partner. The proposals apply to corporations' taxation years ending after March 22, 2011. The proposals have not yet received Royal Assent but it is anticipated that the draft legislation will generally be implemented as proposed.

Which corporations are impacted?

The proposals will apply to a corporate partner (other than a professional corporation) for the partner's taxation year if:

- The corporation is a member of a partnership at the end of the corporation's taxation year;
- The partnership has a fiscal period that is different from the corporation's taxation year end; and
- The corporation, together with related parties, is entitled to more than 10% of the partnership's income or loss.

If the above criteria are met, a partnership can continue to have a fiscal period that differs from that of its corporate partners, but the corporate partner will be required to recognize a notional income amount from the partnership for that part of the corporation's taxation year that falls after the partnership's last fiscal period end (referred to as the "stub period").

Stub period accrual

The stub period accrual is calculated either based on a formula applied to the partnership income for the most recent fiscal year of the partnership or by designating an estimated amount of income for the stub period. Under the formulaic approach, partnership income allocated to a corporate partner for the fiscal period of the partnership ending in the corporations' taxation year is extrapolated for the number of days remaining in the corporation's tax year.

By way of example, assume a corporation has a December 31 year end and the partnership has a January 31 fiscal year end. For the corporate partner's December 31, 2011 year end, it's allocated \$100,000 in income from the partnership's January 31, 2011 fiscal period end. The stub period accrual for the period February 1, 2011 to December 31, 2011 is calculated as \$91,507 ($334/365 \times \$100,000$).

The amount of stub period accrual included in income for the prior year is deductible by the corporation in the following year.

As an alternative to the formulaic approach, the corporate partner may designate any amount of stub period accrual (but not less than zero) for a particular stub period. If a designation is made that results in an income shortfall, the corporation will be penalized and required to include in income in the following taxation year an additional amount determined by a formula that consists of an income shortfall adjustment.

Election to change a partnership's fiscal period

A partnership may wish to change its fiscal period so that it coincides with the taxation year of one or more of its corporate partners. A partnership will have the option to make a one-time election, provided certain conditions are met. The benefit of making this election is that no stub period accrual would have to be reported since the corporate partner would have the same year end as the partnership.

The election must be in writing and filed with the Minister on or before the day that is the earliest filing due date of any corporation that is a member of the partnership for its first taxation year after March 22, 2011.

Transitional relief

Transitional relief is provided to alleviate cash flow problems that would otherwise result from the additional tax burden of reporting up to 23 months of income in one fiscal year. A corporate partner can report the additional income inclusion arising either from the stub period accrual or the change in the partnership's year end gradually over five taxation years as follows: 15% in 2012, 20% in each of 2013, 2014 and 2015, and 25% in 2016.

A corporate partner would claim a reserve for the amount not included in income. The reserve deducted in a particular year is brought into income in the following taxation year. The reserve can be adjusted in the second year to the extent the actual income eligible for transitional relief is different than the initial estimated reserve. Effectively, a corporate partner's taxable income will not be impacted until the corporation's 2012 fiscal year once the stub period accrual is computed for the corporation's 2012 fiscal year.

Impact on joint ventures/co-tenancies

Canada Revenue Agency's administrative position has been to allow a joint venture to establish its own fiscal period that may differ from the fiscal year end of the joint venture participants. In light of these proposed rules, taxpayers who enter into joint venture or co-tenancy arrangements will no longer be eligible to compute income as if the joint venture or co-tenancy had a separate fiscal period end. Transitional relief may be provided similar to the transitional relief described above.

Multi-tier partnerships

A partnership that is a member of a tiered partnership structure may make a "multi-tier alignment election" and select a common fiscal period for the partnerships in the structure. Otherwise, all the partnerships in the structure will be required to have a December 31 year end. Multi-tier partnerships that do not make an election to adopt a common fiscal period will have two fiscal periods in 2011 as a result of the deemed fiscal year end on December 31, 2011.

Summary

The proposals could have a significant impact on the amount of taxable income that must be reported by a corporate partner or corporate joint venture participant. Detailed analysis and planning should be done to determine the impact on cash flow and on which elections and designations (if any) should be made.

Collins Barrow periodically publishes a Tax Flash for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada. While Tax Flash suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.

www.collinsbarrow.com
info@collinsbarrow.com

Clarity Defined.™