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Eliminating the Corporate Tax Deferral Using Partnerships - Resolution 41 of the 2011 Federal Budget



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INTRODUCTION*

One of the changes in the 2011 Federal Budget that sparked my interest was the proposal to limit the tax deferral for corporate partners of a partnership (Resolution 41 of the Notice of Ways and Means Motion). Although the proposed measure is aimed at corporations with significant interests in a partnership, certain aspects of the proposal have broader implications and could impose a significant compliance burden on certain partnerships and their partners.

PERCEIVED INEQUITY

Under the current provisions of the *Income Tax Act (Canada)*, partnerships are generally treated as flow-through entities. The income of a partnership is allocated to the partners at the end of the fiscal period of the partnership. The partners report their share of such income in their tax returns for the year in which the partnership's fiscal year ends.

The current provisions generally do not require a corporate partner to accrue partnership income for the fiscal year of the partnership starting in the partner's taxation year but ending after that year (i.e. stub period). For example, a corporate partner would include its share of partnership income for the fiscal year of the partnership ending on January 31, 2011 in its taxation year ending on December 31, 2011. It would not add the income attributable to the "stub period" from February 1, 2011 to December 31, 2011 in its taxable income for the 2011 taxation year. Since that fiscal period of the partnership would end on January 31, 2012, the partnership income of that fiscal period would be included in the corporate partner's 2012 taxation year and not the 2011 taxation year.

GR Tax Update

The 1995 Federal Budget changed these rules for partnerships of which an individual or a professional corporation is a member. However, the 1995 amendments did not apply to partnerships with partners who were only corporations (other than professional corporations).

Although these general rules relating to the taxation of partnerships have been a part of the Canadian tax system for decades, the Department of Finance has perceived the deferral of tax earned by a corporation through a partnership as being "inequitable". The 2011 Federal Budget proposes to extinguish this "inequity" essentially by requiring corporate partners to accrue stub period partnership income.

OVERVIEW OF THE PROPOSAL

The proposed measure is intended to apply to a corporate partner that has a significant interest in the partnership. Accordingly, the measure will apply only if the corporate partner together with affiliated and related parties is entitled to more than 10% of the partnership's income (or assets in the case of a wind-up) at the end of the last fiscal period of the partnership that ended in the corporation's taxation year. This is the threshold for "significant interest".

There are also other conditions. The corporate partner must be a member of the partnership at the end of the taxation year of the corporation. The partnership's last fiscal period that began in the taxation year must end in a subsequent taxation year of the corporation. In other words, the

partnership's fiscal period must straddle the corporation's year end. In addition, the proposed measure will apply to a corporate partner even if the members of the partnership include individuals or professional corporations.

The proposed measure aims to eliminate the tax deferral by requiring corporate partners to accrue income for the stub period (the "Stub Period Accrual"). The concept of a Stub Period Accrual is intended to represent the partnership income attributable to the stub period.

A corporate partner is offered a choice with respect to how much the partner reports as the Stub Period Accrual. The partner can report an amount by using a formula, which essentially uses the partnership income for the fiscal year ending before the stub period as a proxy for the actual income of the partnership for the stub period (referred to as the "formulaic approach" in the budget materials). Alternatively, the partner can designate an amount that is less than the amount determined by the formulaic approach.

However, a corporate partner will face undesirable consequences if its designation is too low. If the designated amount is less than the lesser of the actual pro-rated income of the corporate partner for the stub period and the amount of the Stub Period Accrual determined under the formulaic approach, then the corporate partner will be required to add an amount to its income in the following taxation year equal to the amount of the short-fall multiplied by the average prescribed

GR Tax Update

interest rate applicable to the underpayment of taxes. The consequences are greater if the short-fall surpasses a 25% threshold.

The Stub Period Accrual could cause a significant increase in the income tax liability of a corporate partner for the taxation year ending in 2011. To mitigate the potential cash-flow impact, the budget provides transitional relief under certain conditions. The relief will essentially allow a corporate partner to spread out the income inclusion over a period of 6 years from 2011 to 2016 as follows: 15% in 2012, 20% in each of 2013 to 2015 and 25% in the final year, 2016.

DO WE HAVE ENOUGH TIME?

Timing is an important consideration. The proposed measure will apply to a taxation year of a corporation that ended after Budget Day (March 22, 2011). Since the taxation year of a corporation may not necessarily be the calendar year, this measure could apply to a taxation year of a corporation that ends as early as March 31, 2011. In addition, there are certain aspects of the proposed budget measure that corporate partners and partnerships might not be able to address quickly.

For instance, the budget proposal allows a corporate partner to reduce the Stub Period Accrual by the amount of the partner's share of certain Canadian resource expenses. To use such expenses to reduce the Stub Period Accrual, the partner will need to obtain from the partnership written information evidencing the nature and amount of such expenses and the

corporate partner's share of such expenses. The partner will be required to obtain such information before filing its corporate income tax return. A partner trying to obtain such information from partnerships might encounter difficulties and unavoidable delays.

The budget proposal offers a one-time election to change the fiscal period of a partnership. A partnership must meet four conditions to make the election. However, two of the conditions will require information that the partnership may not have. One condition provides that the new fiscal period of the partnership cannot end after the latest day that is the last day of the first taxation year that ends after Budget Day of a corporate partner that has been a member of the partnership continuously since before Budget Day. Another condition prescribes that the election must be in writing and filed with the Minister of National Revenue on behalf of the partnership on or before the earliest of all filing-due dates for the income tax return of any corporate partner for the taxation year in which the new fiscal period ends. The partnership may not have this information relating to the taxation years and filing due-dates of its corporate partners. Some corporate partners might be reluctant to provide such information depending on the circumstances. Thus, a partnership could encounter practical difficulties in obtaining such information from corporate partners and experience unavoidable delays.

GR Tax Update

THE TIERED PARTNERSHIP "WRINKLE"- COMMON FISCAL PERIOD

Perhaps, the most significant aspect of the proposed budget measure concerns "tiered partnership structures". According to the budget materials, a tiered partnership structure is a structure where a partnership is a member of another partnership with a different fiscal period. This broad concept of a tiered partnership structure could apply to many partnerships. For these partnerships, the budget proposes a requirement that such partnerships adopt a common fiscal period.

These partnerships have an option. They can make a one-time election to adopt a common fiscal period of their choice. This election is referred to as the "Multi-tier Alignment Election". The elected fiscal period must end before March 22, 2012 and cannot be longer than 12 months. The election must be filed on behalf of the partnerships on or before the earliest of all filing-due dates for the income tax return of any corporate partner of any of the partnerships for the corporate taxation year in which the new fiscal period ends.

However, if the partnerships do not make the Multi-tier Alignment Election, the common fiscal period of a tiered partnership structure will be December 31, 2011 and subsequent fiscal periods will end on December 31. Thus, partnerships in a tiered partnership structure will either share the common fiscal year-end of December 31 or a different fiscal year-end of their choice

pursuant to a Multi-tier Alignment Election.

SIGNIFICANCE OF CHANGING FISCAL PERIODS

The significance of changing the fiscal period of a partnership should not be understated. A partnership generally has only one fiscal period that serves all purposes. It would not have one fiscal period for tax purposes and another fiscal period for other purposes.

The partnership agreement would also set out the provisions that govern the allocation of income and distribution of profit not only for tax purposes but all purposes based on one fiscal period. Determining what fiscal period should be used for a particular partnership would not necessarily be based solely on obtaining a tax deferral. In many cases, that determination could be driven by other factors.

More importantly, once the fiscal period is determined, changing the fiscal period could have a material impact on many partners of a partnership. Accordingly, such a change is probably treated as a fundamental change in respect of which a special resolution (75% of the votes) may be required in many partnership agreements. In addition, partners may have different year-ends making it difficult for partners to agree on what the new year-end should be especially if they have different year-ends. Thus, changing a fiscal year-end for some partnerships might be a non-starter.

However, a partnership in a tiered partnership structure does not have a choice under the proposed budget

GR Tax Update

measure. It must either adopt a December 31 year-end or a common fiscal year-end by making an election with all other partnerships in the tiered structure.

This aspect of the proposal could impose a significant compliance burden for such partnerships. Trying to coordinate the negotiation of a common fiscal period in a tiered structure could be challenging if not impossible depending on how many stakeholders are in the partnership structure at different levels especially in a context requiring a special resolution. The requirement to adopt a common fiscal period was also probably not contemplated by existing partnership agreements. Consequently, such partnerships will need to consult with legal counsel to determine how to implement the change without violating the partnership agreement.

In addition, trying to deal with the transition to a common fiscal period within the timeline contemplated by the budget proposal might be difficult. The transition to a common fiscal period will likely require the involvement of lawyers and accountants, as well as meetings and discussions with the stakeholders. All of this could require a significant amount of time.

These potential complexities prompt us to consider whether the Department of Finance has thoroughly considered the ripples that this aspect of the proposal could cause. At minimum, it might be necessary to provide more time for partnerships to consider the implications of the proposal and

complete the transition to a common fiscal period.

CLOSING COMMENTS

The dissolution of Parliament has stalled the legislative process. All draft legislation including the 2011 federal budget proposals have been terminated. There will be no legislative developments until Parliament resumes after the election. However, it is quite possible that the budget proposal to limit the tax deferral for corporate partners (Resolution 41) could be re-tabled in its current form when Parliament resumes. Finance Minister Jim Flaherty has indicated that he will bring back the same budget proposals if the Conservative Party is re-elected. In addition, some of the budget measures including Resolution 41 could be brought back regardless of which political party wins the election. There is also no guarantee that the application dates will be deferred. Accordingly, it would be prudent for corporate partners, partnerships and their tax advisors to use the extra time to consider the impact of this budget proposal on partnerships and their partners.

For more information about the topic discussed in this article, please contact Peter Baek.

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