CANADIAN TAX Highlights

Editor: Vivien Morgan, LL.B.

Volume 19, Number 11, November 2011

Partnership Income Deferral Limited

The budget implementation Bill C-13 includes new rules that limit the opportunity for a corporation to defer income earned through a partnership whose fiscal period ends after the corporation's tax year-end (sections 34.2 and 34.3). The anti-deferral rules apply to taxation years ending after March 22, 2011. The stated policy objective is simple, but the proposed legislation is complex and requires close scrutiny to raise awareness of the wide variety of events that can trigger unexpected negative or positive tax consequences. The CRA website notes that forms and software have not yet been updated to reflect the rules and provides some interim guidance on reporting and alignment elections.

Generally if a corporation's taxation year ends prior to the fiscal period-end of a partnership in which it has a significant interest (generally more than 10 percent), the anti-deferral rules require an income inclusion for the stub period (the adjusted stub period accrual, ASPA), in addition to the regular partnership income inclusion under subsection 96(1). The use of the word "accrual" in ASPA is a misnomer: the income inclusion for the stub period after the corporate year-end is merely a calculated proxy for the corporation's share of the partnership income actually earned in the stub period. Very generally, the ASPA is the partner's income allocation for the partnership's latest fiscal period multiplied by the number of days in the stub period divided by the number of days in the partnership's latest fiscal period. At the corporation's year-end it must include its share of the income from the preceding partnership year, plus its ASPA. To avoid a double counting, the corporation may deduct any ASPA that had been included in its previous year's income, because that amount is included in its share of the partnership's actual income for the latest fiscal period.

Two optional deductions can reduce the ASPA for a year. A deduction may be taken for an amount in respect of the partnership's stub period "qualified resource expense", which recognizes that resource expenses are not deducted at the partnership level but are allocated to the partners at the partnership's fiscal period-end. A deduction may also be taken for any amount that the partner chooses to designate: this designated amount has no limits, but generally an income inclusion arises in the subsequent taxation year if the designated amount causes the ASPA to be less than a pro rata portion of the actual partnership income allocated to the partner for the partnership's fiscal period ending after the taxation year-end. The subsequent year's income inclusion generally equals the interest on the deferred tax plus in some circumstances a de facto penalty. Often the corporate partner knows the amount of the deferral partnership's actual stub period income before the corporate return must be filed, and thus the designated amount can be used to reduce the ASPA if the actual share of partnership income fell relative to the prior period. However, if partnership income rose relative to the prior period, no mechanism in the anti-deferral rules limits the deferral on that income growth.

Transitional relief recognizes that an acceleration of income can have a significant adverse cash flow effect on a corporate taxpayer. A corporate partner's "qualifying transitional income" (QTI) initially corresponds to its ASPA for its first taxation year ending after March 22, 2011 and any "eligible alignment income". If the deferral partnership structure continues, initial QTI generally is re-calculated for the second and subsequent taxation years based upon the actual income earned during the first stub period. Once established, QTI becomes the basis for the QTI reserve. A specified percentage of QTI can be deducted over six years, starting at 100 percent and decreasing to nil. Like other reserves, the QTI reserve is deducted in one year and included in income in the next year, and thus the QTI is smoothed over six years. The ability to claim the QTI reserve may be lost in many circumstances and thus is particularly important to consider in acquisitions, divestitures, and reorganizations.

The rules provide a limited opportunity to change a partnership's fiscal period without the minister's consent. Notwithstanding the draft legislation's references to "alignment", there is no need to choose a fiscal period that aligns with any of the partners' year ends and no mechanism by which corporate partners with different year ends can align their year ends. Moreover, although an alignment of the fiscal period-end with the corporate partner's taxation year-end can mitigate the anti-deferral rules, most often that alignment does not eliminate the need to calculate QTI and the QTI reserve, and depending upon the structure, may not eliminate future consideration of the complex anti-deferral rules.

For purposes of alignment, the rules distinguish single tier structures, in which all partners are corporations and the partnership is not itself a partner in another partnership, and multi-tier structures, in which a partnership is a partner in another partnership. For a single tier structure, fiscal period alignment is entirely optional: an election may be filed by the earliest filing-due date for any corporate partner's first taxation year ending after March 22, 2011. In some cases this filing deadline may already have passed: if one corporate partner has a March 31 taxation year end, the election was due September 30, 2011. No provision has been made for the late filing of the appropriate election even though Bill C-13 was only tabled on October 3, 2011 and has not yet been enacted.

For the multi-tier structure, fiscal period alignment of a sort is mandated. Unless an election is filed on behalf of all the tiered partnerships, the fiscal period-end for each partnership is changed to December 31, even if no other partner has a calendar year-end. The election due date is as discussed for a single tier structure. The date selected in the election for the fiscal period year-ends need not align with the year-ends of any or all of the corporate partners, and thus the multi-tier "alignment" election may be made in order to maintain a deferral partnership fiscal period-end. A corporate group that does not use December 31 year ends and that does not contain a tiered or deferral partnership structure may be caught unawares by a reorganization or acquisition of publicly traded limited partnership investments that triggers the anti-deferral rules and a forced December 31 partnership fiscal period-end.

Brett Anderson and Anthony Strawson
Felesky Flynn LLP, Calgary