

budget 2011: partnership deferral benefits eliminated

Budget 2011 proposes to eliminate the deferral advantage that was typically available in respect of income earned by corporations through a partnership.

Historically, under the *Income Tax Act* (Canada) (the “**Tax Act**”), income from a partnership was calculated at the end of the fiscal period of the partnership; however, each partner’s share of the income was only taxed in the taxation year of the partner that included the fiscal year end of the partnership. Under this system, a thoughtful selection of the fiscal year end of a partnership relative to the taxation year ends of any corporate partners allowed for a deferral of tax. Specifically, the selection of a partnership fiscal year that ended just after the taxation year end of a corporate partner generally provided the maximum amount of deferral. For instance, a partner with a taxation year that ended December 31, 2009 might have selected a fiscal year for the partnership that ended January 31, 2010. Under such circumstances, all of the income earned by the partnership from February 1, 2010 to December 31, 2010 (or 11 months of the year) would not be included in the partner’s income until its 2011 taxation year. By contrast, if the fiscal period for the partnership had ended on December 31, 2009 (the same as the corporate partner’s taxation year end) or earlier, all of the relevant partnership income for that same period would have been included in the income of the partner for its 2010 taxation year.

The ability of individual partners to defer the recognition of partnership income was eliminated by amendments to the Tax Act in 1995 (after several large professional firms set up multi-tier partnerships to extend the deferral beyond one year). Budget 2011 proposes to implement a similar regime in respect of corporations.

who is subject to the new rules?

The new rules generally apply to corporate partners (other than professional corporations) that, together with affiliated and related parties, are entitled to more than 10% of a partnership's income (or assets on a dissolution) if (i) the fiscal period of the partnership that began in the taxation year of the corporate partner ends in a subsequent taxation year, and (ii) the corporation is a partner at the end of its taxation year.

how is the deferral eliminated?

Under the new proposals, a partnership will still be permitted to have a fiscal period that is different from the taxation year of its corporate partners, which only makes sense since, in many cases, the partners of the partnership would have different taxation year ends. Any deferral is avoided by requiring each corporate partner to include in income for each taxation year (i) the partner's share of partnership income for the fiscal period of the partnership that ends in that taxation year (as it would under the old system), *plus* (ii) an estimate of the partner's share of the partnership income for the period from the fiscal year end of the partnership to the taxation year end of the partner (the "**Stub Period Accrual**"), *less* (iii) the estimate of the partner's Stub Period Accrual that was included in the partner's income for the prior taxation year.

how do you estimate the stub period accrual?

A partner can select one of two methods to estimate its Stub Period Accrual. The first method (referred to in the Budget as the "Formulaic Approach") is based on the income earned by the partnership for the fiscal period which ended in the taxation year of the corporate partner (the "**Completed Fiscal Period**"). Under the Formulaic Approach, the partner simply multiplies its share of partnership income (other than dividends) for the Completed Fiscal Period by a fraction, the numerator of which is the number of days in the stub period and the denominator of which is the number of days in the fiscal period of the partnership which ended in the taxation year. In the example presented

above, where the partner's taxation year ended on December 31, but the partnership's fiscal period ended on January 31, the corporate partner would be required to include in its 2011 income its share of the partnership's income for the fiscal period that ends January 31, 2011, plus approximately 11/12 of that income as an estimate of its share of the partnership's income for the period from February 1, 2011 to December 31, 2011, less the amount of the Stub Period Accrual included in income for the prior taxation year, which, in the first year of application of the new rules, would be nil.

Instead of using the Formulaic Approach, the partner may alternatively simply elect to designate a lower amount as its Stub Period Accrual (referred to in the Budget as the "Designation Approach").¹ Presumably, a partner would utilize the Designation Approach if it expected its actual Stub Period Accrual in respect of the partnership to be less than its share of the partnership income for the Completed Fiscal Period (i.e., either because it expects the partnership's income to decline or its share of that income to decrease).

However, if the partner uses the Designation Approach and if both (i) the partner's actual Stub Period Accrual, and (ii) the amount that would be determined by applying the Formulaic Approach are greater than the amount designated by the partner, the partner will generally be required to include an additional amount in income in the following taxation year when the actual Stub Period Accrual is ascertained. The additional amount is generally equal to interest at the prescribed rate on underpayments of tax on the amount of the difference between the amount designated by the partner and the lesser of the actual Stub Period Accrual and the amount that would have been determined under the Formulaic Approach. In many ways, this mechanism mimics the approach taken with a taxpayer's obligation to make instalment payments. A taxpayer can base its instalment payments on the previous year's taxes or base its instalments on its estimate of taxes to be paid for the current year. If the taxpayer uses the prior year method, no interest is payable if the taxes for the current year exceed the instalments

¹ Special designation rules will apply in respect of "designated resource expenses" incurred by the relevant partnership in the Stub Period.

paid, but if the taxpayer uses the estimate method, it is liable for interest on the underpayment.

penalty for under-estimating stub period accrual

Like the tax rules applicable to tax instalment payments, Budget 2011 also proposes the application of a penalty if a partner's estimate of its Stub Period Accrual under the Designation Approach is too low compared to actual results. If the partner's estimated Stub Period Accrual is less than 75% of the lesser of the actual Stub Period Accrual and the Stub Period Accrual that would be determined under the Formulaic Approach, the partner is effectively subject to a penalty as it is required to include in income for the subsequent year a further amount equal to 50% of the notional interest inclusion attributable to the shortfall below the 75% threshold.

application of the new rules and a reserve to spread the pain

The new rules, if passed, will apply in respect of the first taxation year of a corporate partner that ends after March 22, 2011. In their first year of application, the new rules may have a dramatic impact on a corporation's income from a partnership, effectively doubling the income from a partnership for those partners that had previously obtained the maximum deferral benefit by arranging for the partnership fiscal period to end shortly after the partner's taxation year end.

To alleviate the harshness of this result, the new rules will generally allow the partner to claim a reserve so that the inclusion of the first year's Stub Period Accrual is spread over the following five years, in the following percentages: 15% in the second year of the rule's application, 20% over the next three years and 25% in the sixth year.

For the purpose of computing the reserve, the Stub Period Accrual will be computed on the basis that the partnership claimed the maximum possible amount of reserves, allowances

and other discretionary deductions to prevent the partnership from maximizing the income eligible for the reserve.

changing a partnership's fiscal period

To avoid some of the complexity created by the proposed rules, partners may decide (particularly if all partners have the same taxation year end) to take advantage of an election that allows a partnership to change its fiscal period. This election is available if all of the partners of a partnership are corporations other than professional corporations. The new fiscal period must end after March 22, 2011 and no later than the taxation year end of the partner (that has been a member of the partnership since before March 22, 2011) whose taxation year for the current year is the last to end. If this election results in income from two fiscal periods of the partnership being included in a partner's income in the first taxation year of the rules' application, the amount of income arising from the second fiscal period is eligible for the reserve for Stub Period Accrual.

multi-tiered partnerships

If a partnership is a partner in another partnership, the new rules will require that both partnerships have the same fiscal period. The partnerships may select any date as the end of their common fiscal period so long as it occurs before the first anniversary of the Budget Day and no partnership's fiscal period exceeds 12 months. If the partnerships do not select a common fiscal period, the fiscal period for the partnerships will end on December 31, 2011.

If the change in fiscal period of the partnerships in a multi-tiered partnership structure results in any of the end partners, or any of the intermediary partnerships, being required to include the income from two fiscal periods of a partnership into a single taxation year or fiscal period, the end partner will be eligible to claim a reserve for the income from the second fiscal period similar to the reserve available for the Stub Period Accrual of single tier partnerships.

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[a cautionary note](#)

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