## *READING 7-1*

# Definition

LEVEL 2

The ITA does not define the term "partnership," but outlines the tax consequences where a partnership exists. Section 102 defines what is meant by a "Canadian partnership" but presupposes that there is a partnership. A partnership (unlike a corporation) is not a *person*, nor is it deemed to be within the meaning of the ITA, even though section 96 provides that the income of a member of a partnership is computed as if the partnership were a separate person (IT-90). This nuance will explain the particular tax treatment of income from a partnership, which is quite different from that of a corporation, as well as the difference between calculating the ACB of a partnership interest and that of shares of a corporation.

Generally speaking, a partnership is the relationship that exists between persons carrying on business in common with a view to profit. However, co-ownership of one or more properties not associated with a business does not in itself create a partnership. This is so regardless of any arrangement that may exist to share profits and losses. For guidance on whether a particular arrangement constitutes a partnership, reference should be made to the relevant provincial law on the subject, as such law will be viewed as persuasive by CRA.

Formal registration of a partnership is not in itself decisive because a declaration of this type does not prevail in partnership law over the actual facts of a situation.

It should be noted that a partnership may exist even in the absence of a written partnership agreement; the existence may be demonstrated by the particular facts. However, jurisprudence has shown that even if persons carrying on business characterize their relationship as a partnership in writing, this fact is not necessarily decisive. It may be necessary to consult a legal expert.

# *READING 7-1A*

# Partnership — nature

LEVEL 2

## Relation between partnership and business

What is partnership? **Partnership** is the relation between parties who carry on business in common with the intention of making a profit. The concepts of business and business in common are central to understanding partnership.

A partnership is more than a joint enterprise. People who come together for fun, such as agreeing to form a relay team for a race, are not engaged in business. Likewise, owning property in association with others and collecting rent is not necessarily carrying on a business. Consequently, although these activities are joint enterprises undertaken for their potential to make a profit — the members of the relay team may agree to race in order to win the prize — they are not partnerships because they are not **business activities**. The relay team is not considered a business because it is unlikely that profit is the main intention and purpose of the undertaking, nor is the team likely to break even over a period of time. As for the property owners, they are not considered a business because they are not *actively* engaged in the management of property. No staff is being hired; they are passively collecting a return from their investment.

The business must also be a **business in common**. Merchants who form a pool in order to obtain a lower freight rate for their goods have formed a joint enterprise in order to make a profit. They have joined for a common purpose, but they are not carrying on business in common; consequently, they have not formed a partnership.

A partnership does *not* have a **separate legal identity** from the parties who make up the partnership. An incorporated company has a legal identity that is distinct from its shareholders. This means that the shareholders are not responsible for the debts or the actions of the company; creditors cannot seize the assets of the shareholders of the company to satisfy the debts that they are owed. Partnerships do not have a legal identity that is separate from the partners; the partners are the partnership and are personally responsible for the debts and the actions of the partnership.

For example, Carson and Debra are accountants and have formed a partnership. Their office manager purchases a computer from Data. If the partnership does not pay Data for the computer, Data may require Carson and Debra to pay for the computer from their personal funds because each partner is individually responsible for the debts and actions of the partnership.

Because each partner is personally responsible for the totality of the obligations of the partnership, it is very important that business associates do not inadvertently form a relationship which will subsequently be deemed to be a partnership.

### *Evidence of partnership*

A partnership may exist even if the individuals involved have not agreed either orally or in writing to form a partnership. Courts may find that a partnership exists even if the individuals involved expressly state that they have not formed a partnership. Its existence may simply be deduced from the conduct of the parties regardless of their intent to form a partnership.

For example, Ken purchases a truck to haul gravel. Ken asks Chuck if he will drive the truck late afternoons and early evenings. Ken will drive the truck mornings and early afternoons.

Chuck will receive 40% of the profits, that is, income after expenses. Ken and Chuck will both look for work for the truck. Therefore, Ken and Chuck have formed a partnership.

The courts will refer to various rules in order to determine whether the parties' consent indicates they have formed a partnership. First, each of the parties must have made a **contribution to the capital** that established the business. Second, each of the parties must take an **active role** in the conduct of the business, especially in making decisions on important matters. Third, the parties must **share the expenses and the profits** flowing from the joint enterprise; this means that sharing of gross receipts does not create a partnership. Each of these conducts is evidence that a partnership exists although the rules are not conclusive evidence. In addition, the parties' conduct should display a **motive for profit**. The parties should be actively pursuing the business as a means of earning income, not just as something to do in their spare time and without regard for covering their costs. Otherwise, the joint enterprise is more likely a hobby they share in common than a business. In coming to their decision, the courts will look at the *substance* rather than the *form* of the relationship.

Parties in a joint enterprise should exercise great care that they do not inadvertently form a partnership by estoppel, that is, lead others to believe, by words or conduct, that the parties to the joint enterprise are engaged in a partnership. This can easily occur, much to their chagrin.

## Separate personality of partnership and liability of partners

A partner is both the principal and the agent of the other partners. Because a principal is bound by the actions of its agent, a partner's actions will bind its partners. The partner will also be bound by the actions of its partners within the scope of the partner's apparent authority, unless the third party is aware of special limits on this actual authority.

José, France, Ron, and Catharine are accountants. Their partnership agreement states that all contracts are to be approved by two partners before being accepted. José accepts a contract with Marita to prepare financial statements. France, Ron, and Catharine will be bound by the contract with Marita because José acted within the scope of his apparent authority and Marita had no notice of any special limits on José's authority. The other partners could sue José on the partnership agreement for breach of contract.

Because each partner is the principal of the other partners, each partner is **liable** for the totality of the debts of the partnership; and because the partnership does not have a separate legal identity from the partners, the personal assets of each partner (for example, home, personal bank account, RRSPs, and car) are available to satisfy a debt incurred by one or all of the partners in the course of the partnership business.

For example, José, France, Ron, and Catharine's partnership agreement specifies that José will receive 10% of the partnership profits, France and Ron 20% each, and Catharine, 50%. They will also share losses in the same proportion. The partnership owes $100,000 to Marita; liquidation of the partnership assets nets $60,000. José has an RRSP worth $50,000; Marita can recover the balance of $40,000 from José. José can sue the other partners on the partnership agreement to recover the $36,000 that José was required to pay in excess of the amount stipulated in the partnership agreement.

The lack of separate legal identity for the partnership also means that a partner's share of the partnership assets is available to satisfy its personal creditors. For example, José purchases a sailboat and later declares personal bankruptcy. There is $75,000 owing on the sailboat; the creditor can recover the balance of the debt owing from José's share of the partnership assets.

## Registration of partnerships

The government requires certain types of partnerships to be **registered** in order to facilitate litigation; by consulting the registry, a prospective plaintiff can easily identify the other partners and serve them with a copy of the statement of claim when beginning litigation. Creditors also find the partnership registration useful; it allows them to verify the information given to them about the members who comprise the partnership. When terminating the partnership relation, the former partners should ensure that their names are removed from the partnership registration; otherwise, they may be held to have continued to be a partner by estoppel.

## Summary/analysis of nature of partnership

To analyze a case dealing with the nature of a partnership, ask the following questions:

1. Is the joint enterprise engaged in business and is it a business in common?
2. Does each of the parties take an active role in the conduct of the business, especially in decisions on important matters?
3. Do the parties share the expenses and the profits flowing from the joint enterprise?
4. Does a partner have personal assets available to satisfy partnership debts?
5. What is the partner's share of partnership assets that must be made available in order to satisfy the partner's personal creditors?
6. If the partner has left the partnership, was the debt incurred after leaving the partnership but before notifying the creditor of the partner's departure?

# READING 7-2

## Computation of income

LEVEL 1

### General comments

A partnership is not a person, nor is it deemed to be a person, but the partnership computes its income as if it were a person. A share of the partnership's income or loss from each source is transferred to the partners and retains its characteristics, source, and nature. For example, a taxable dividend that the partnership receives from a Canadian corporation is taxed as such when allocated to the partners.

Since a partnership is not a person within the meaning of the definition given in subsection 248(1), you will have to read all provisions of the ITA carefully to determine whether or not they apply to a partnership. Thus, when subsection 85(1) states "Where a taxpayer...", and hence a person according to the definition of taxpayer given in subsection 248(1), this does not include a partnership. Instead subsection 85(2) specifies that most of the paragraphs of subsection 85(1) apply (by adapting them) to a partnership if certain conditions are satisfied. If no such stipulations existed, a partnership could not carry out a rollover to a corporation, since it is not a taxpayer.

Although a partnership must in some cases file an information return, *it does not file an income tax return and does not pay income tax.* Rather, the partnership's income is allocated to the partners who are taxed on such income, or are entitled to a deduction if the partnership incurs a loss. Thus, the tax consequences of the transactions carried out by the partnership show up on the income tax return of each of the partners.

Subsection 96(1) contains general rules for the computation of a taxpayer's income or loss arising from a partnership as if

- the partnership were a separate person resident in Canada
- the partnership's taxation year were its fiscal period
- each partnership activity were carried on by it as a separate person
- each partner shared in the income under the terms of the agreement
- the various sources of the partnership's income do not lose their characteristics when allocated to the partners
- the research and development expenditures incurred during the year were deducted in the year

In addition, section 103 makes it possible for CRA to establish a different distribution of the results of the partnership than the one the partners established, if CRA considers the different distribution more reasonable in the circumstances.

The remuneration paid by the partnership to the partners is not an expense for the partnership, but rather a method of distributing the income of the partnership. If the income earned by the partnership during the taxation year is less than the remuneration that the partnership is required to pay the members, the excess reduces the members' capital accounts. This reduction is then allowed as a deduction in computing the amount of the income or loss of the partnership allocated to members.

EXAMPLE 7-1

Joseph Smith and Aline Roy are members of the partnership Unique. Under the partnership agreement, Joseph is entitled to annual remuneration of $15,000, after which Joseph and Aline share in the profit or loss equally.

| | |
|---|---|
| Partnership profit | $ 10,000 |
| Joseph's remuneration | (15,000) |
| Partnership loss to be distributed equally | $ (5,000) |

An amount of $2,500 is thus deducted from the capital account of each partner, Joseph and Aline.

Joseph's income

| | |
|---|---|
| Remuneration (attributed profit) | $ 15,000 |
| Loss allocated to Joseph | (2,500) |
| | $ 12,500 |

Aline's income

| | |
|---|---|
| Loss allocated to Aline | $ (2,500) |
| Total income reported by the two partners, being the partnership's profit | $ 10,000 |

## Selecting a fiscal period

The fiscal period of an individual who carries on a business must end on December 31, unless he elects to have it end on another date. In the latter event, he uses the alternative method in order to report his income as if his period ended on December 31.

A partnership may decide the date on which its fiscal period ends, unless one of the partners is an individual. In that case, the fiscal period ends on December 31 unless an election is filed.

Where one member of a partnership is an individual, the fiscal period of the partnership ends on December 31. However, under subsection 249.1(4), a partnership may also elect in prescribed form to have its fiscal period end on a date other than December 31, if

- each member of the partnership is an individual including a testamentary trust, and
- the partnership is not a member of another partnership.

The election is made by filing Form T1139, "Reconciliation of Business Income for Tax Purposes" when the business begins operating. The filing deadline is the earlier of the filing deadlines applicable to the partners for the taxation year in which the business carried on by the partnership began operating.

Example 7-2 shows a situation in which a date other than December 31 may be chosen for the end of the fiscal period.

EXAMPLE 7-2

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Brigitte Marchand starts carrying on a business on June 1, 2008, as a partner of Treasury Gallery. The only other partner in Treasury Gallery is:

1. Electronic Ltd., whose fiscal period generally ends on March 31.

or

2. Boris Milo

The fiscal period of Treasury Gallery must end on December 31, since one of the partners is an individual.

In the first situation, where Brigitte's partner is a corporation, no election can be made to have a fiscal period end on a date other than December 31.

In the second situation, where Brigitte's partner is an individual, the partnership may elect to have its fiscal period end on another date by filing Form T1139 no later than the first of the following dates:

- June 15, 2009, the date by which Brigitte must file her income tax return for the 2008 taxation year
- June 15 2009, the date by which Boris must file his income tax return for the 2008 taxation year

Any fiscal period end date that would suit the partnership would be acceptable, provided that the fiscal period does not exceed 12 months

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However, even if a partnership satisfies the criteria set out in subsection 249.1(4), it is not entitled to use the alternative method if its expenditures are made up primarily of the cost or CCA of tax shelter investments, as stated in subsection 249.1(5). This situation usually concerns limited partnerships.

The partners must include in their income their share of the partnership income or loss earned during the fiscal period of the partnership ending in the calendar year (taxation year of an individual) or in its fiscal period (taxation year of a corporation).

However, in the case of a partnership in which all of the partners are individuals and which made the election under subsection 249.1(4) in order for the fiscal period of the partnership not to end on December 31, certain adjustments must be made to the partner's income, because the alternative method is used.

For example, assume that the fiscal period of a partnership which consists solely of partners who are individuals, and which elected to use the alternative method, ends on January 31, 2008. The profits for the period ending January 31, 2008, are added to the 2008 income tax return. In addition, under section 34.1, the portion of estimated income attributable to each of the partners for the period from February 1, 2008, to December 31, 2008, computed according to the alternative method, is added to the 2008 income tax return. And if in 2007 an amount was added to the partner's income due to the use of the alternative method, it is deducted in computing 2008 income in order to prevent double taxation, since it is included in the partnership's real fiscal period, ended January 31, 2008.

Example 7-3 illustrates such a situation.

EXAMPLE 7-3

Alexis Bégin and Sandra Tocok are the two equal partners in Modern Gardens, the fiscal period of which ends on January 31. Since 1998, the partnership elected to have its fiscal period end on January 31, because it is a seasonal business. Modern Gardens thus used the alternative method to calculate its income. The business income for the periods ended January 31, 2007, and 2008 was $57,700, and $70,000 respectively.

2008

| | |
|---|---|
| Income for period ended January 31, 2008 | $ 70,000 |
| Additional business income for 2008 ($70,000 × 334 ÷ 365) | 64,055 |
| Additional business income for 2007 ($57,700 × 334 ÷ 365) | (52,799) |
| Business income | $ 81,256 |

Each partner must include in his or her 2008 income an amount of $40,628 as business income from Modern Gardens.

Under subsection 249.1(6), the partners may revoke the election to use the alternative method. As a result, the partnership's fiscal period will end on December 31, for the year of the election and for all subsequent years.

Where a partnership ceases to exist, its fiscal period is deemed to have ended immediately prior to dissolution [subsection 99(1)]. However, the individual may, for purposes of computing income, elect to have the partnership's fiscal period end at the time it would normally have ended if the partnership had not ceased to exist [subsection 99(2)]. This election is personal and does not bind the other partners. This election is not available to a partner that is also a partnership or a corporation, nor is it allowed if the partnership's fiscal period ends on a date other than December 31.

Subsection 99(3) disallows the election in subsection 99(2) for an individual not resident in Canada at the time the fiscal period of the partnership is deemed to have ended.

## Capital cost allowance

In computing partnership income or loss, CCA on property owned by the partnership for the purpose of earning income is claimed by the partnership and not by the partners. Given that a CCA deduction allowed under paragraph 20(1)(a) of between zero and the maximum for the class may be claimed, the partners should agree on the deduction to be claimed by the partnership. In addition, any recapture of CCA, as well as any terminal loss, will be included in computing partnership income.

As for any other business, if the taxation year of the partnership is less than twelve months, REG 1100(3) restricts the CCA that may be claimed on most assets to the proportion that the number of days in the taxation year is of 365.

CCA that may be claimed in the year of acquisition of an asset is limited to one-half of the rate allowed for the class under REG 1100. This rule also applies to depreciable property acquired by a partnership.

Partnerships are also subject to REG 1100(11) and (15), which provide that a loss on rental property or leasing property cannot be created or increased through CCA. Members of the partnership may also be restricted in the CCA they may claim on rental property held personally if the partnership incurs such losses.

EXAMPLE 7-4

| | Situation 1 | Situation 2 |
|---|---|---|
| Partnership's rental income before CCA | $ 45,000 | $ (24,000) |
| Maximum CCA that may be claimed | (7,000) | — |
| Net rental income (loss) | $ 38,000 | $ (24,000) |
| Alain Simard owns a 50% interest in the partnership. His share of partnership rental income (loss) is: | $ 19,000 | $ (12,000) |
| Alain also owns rental property personally, the income for the year being as follows: | | |
| Rental income (loss) before CCA | $ (16,000) | $ 18,000 |

The maximum CCA amount allowable to Alain on the personally owned rental property is $5,000.

***Tax consequences***

For Alain:

| | | |
|---|---|---|
| Rental income (loss) before CCA | $ (16,000) | $ 18,000 |
| Net rental income from the partnership | 19,000 | (12,000) |
| Net rental income | 3,000 | 6,000 |
| Maximum CCA that may be claimed by Alain | (3,000) | (5,000) |
| Net rental income for Alain | $ — | $ 1,000 |

## Rent paid by the partnership to a partner

If a partnership is the renter of property belonging to a partner, the rent is a deductible expense for the partnership and income for the partner, and it is not an allocation of partnership income.

## Dividends

When a partnership receives dividends from a taxable Canadian corporation, and there are expenses applicable thereto, CRA considers that the partnership may allocate to each member his share of the expenses. The gross-up of the dividend and the dividend tax credit are calculated by the partner on the dividend itself rather than on the net dividend income.

EXAMPLE 7-5

Winnie Wong and Jack Black are equal partners in the partnership Ginkgo. The partnership earns income from eligible dividends of taxable Canadian corporations.

Ginkgo:

| | |
|---|---|
| Taxable dividends received in 2008 | $ 15,000 |
| Loan interest | (3,000) |
| Net dividends | $ 12,000 |

***Tax consequences***

For Winnie and Jack each:

| | |
|---|---|
| Taxable dividends | $ 7,500 |
| Loan interest | $ 1,500 |

Amount to be included in Winnie's and Jack's income:

| | |
|---|---|
| Dividends received | $ 7,500 |
| Gross-up: 45% | 3,375 |
| Taxable dividends | 10,875 |
| Loan interest | (1,500) |
| Net dividend | $ 9,375 |
| Dividend tax credit (11/18 × $3,375) | $ 2,063 |

Dividends paid from the payor's CDA are allocated to each partner. They retain their characteristics and constitute a tax-free dividend.

## Automobile provided to partner

If during the year the partnership makes an automobile available to a partner or a person related to a partner, under paragraph 12(1)(y) an amount computed in accordance with paragraph 6(1)(e) is to be included in the partner's income.

## Disposition of capital property

Under subparagraph 96(1)(c)(i), where a partnership disposes of capital property, the *taxable* capital gain and the *allowable* capital loss must be allocated to the partners. However, where a partnership disposes of listed personal property as defined in section 54 (works of art, jewellery, stamps, etc.), the entire capital gain or loss must be allocated to the partners. Under subsection 41(2), in computing his net gain from the disposition of listed personal property, a partner adds his gains and losses to all other capital gains or losses from the disposition of listed personal property. This is because losses from the disposition of listed personal property are deducted in computing the net gain and not in computing the taxable capital gain.

LEVEL 2

## Application of the debt forgiveness rules

You previously studied the application of the debt forgiveness rules for an individual and a corporation. However, partnerships are governed by different rules than individuals and corporations.

You learned that, with respect to debt forgiveness, the forgiven amount serves to reduce, among others, the following:

- the debtor's non-capital loss, farm loss, and restricted farm loss carryforwards under subsection 80(3)
- the debtor's business investment loss and net capital loss carryforwards under subsection 80(4)
- the capital cost of the debtor's depreciable property and the UCC under subsection 80(5)
- the debtor's CEC under subsection 80(7)
- the ACB of certain capital properties, except for an interest in a partnership related to the debtor under subsections 80(9) to 80(11)

Since a partnership is not a taxpayer, it cannot take advantage of loss carryforwards under the provisions of section 111 because they only apply to taxpayers. Thus, the rules set out in subsections 80(3) and 80(4) do not apply to debt forgiveness in favour of partnerships.

Under subsection 80(13), where a commercial obligation issued by a partnership is settled for a nil amount, 100% of the forgiven amount that remains unused after the application of subsections 80(5) to 80(11) is added in computing the partnership's income rather than 50% as in the case of any other debtor. The income source is deemed to be the source in connection with which the obligation was issued. The income or loss attributed to each of the partners for the partnership's fiscal period is therefore affected by this additional income due to the debt forgiveness. The ACB of the interest is then increased under paragraph 53(1)(e), as for any other income attributed to a partner.

In order to lessen the immediate tax consequences of additional income, a partner may claim a deduction, under paragraphs 80(15)(a) and 20(1)(uu), of an amount equal to this additional income. Since income resulting from the application of subsection 80(13) is deemed to come from a separate source, the expenses of the partnership for the current year do not affect the calculation of the deduction provided for in subsection 80(15).

If the partner claims the deduction of an amount under subsection 80(15), he is deemed to have issued a commercial obligation that was settled at the end of the partnership's fiscal period during which the debt of the partnership was settled. The amount of the deduction claimed by the partner is treated as if it were the amount forgiven on the deemed obligation.

The partner is then in the position of a debtor to whom debt forgiveness has been granted, and the provisions of subsections 80(3) to 80(8) apply. For example, if he has a debt balance to carry forward, it will be reduced all or in part, as the case may be, by the amount of the deduction claimed under subsection 80(15). If a balance remains, under subsection 80(13), 50% of the amount forgiven is added to the partner's income.

These provisions are illustrated in Example 7-6.

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EXAMPLE 7-6

Irène Ménard and Ken Li are equal members of a partnership. As at January 1, 2008, the ACB of Irène's interest is $10,000. The ACB of Ken's interest is –$8,000. A $30,000 debt payable by the partnership was settled for a nil amount and, thus, there is a forgiven amount of $30,000. The amount of relevant expenses or costs in reduction of which the forgiven amount could have been applied under subsections 80(5) to 80(11) is nil. The partnership's fiscal period ends December 31, 2008. Assume that the partnership is inactive and there is no income or loss for the fiscal period concerned.

***Tax consequences***

1. Under section 96 and subsection 80(13), Irène and Ken must each add $15,000 to their 2008 income, representing their share of the income from the partnership. This inclusion has the effect of changing the ACB of each partner's interest. As at January 1, 2009, Irène has an ACB of $25,000 and Ken has an ACB of $7,000.

2. Under paragraph 80(15)(a), Irène and Ken can claim a maximum deduction of $15,000 each in computing their income. This provision totally cancels out the amount added to their income in 1 above, but it has no effect on the calculation of the ACB of the interest in the partnership.

3. If Irène claims the $15,000 deduction under paragraph 80(15)(a), that amount constitutes a forgiven amount. If she has none of the tax components that can be reduced under subsections 80(3) to 80(8), she can, under subsection 80(9), apply the $15,000 amount to reduce to $10,000 ($25,000 – $15,000) the ACB of her interest in the partnership.

4. If Ken claims the $15,000 deduction under paragraph 80(15)(a), that amount is also considered a forgiven amount. If Ken has none of the tax components that can be reduced under subsections 80(3) to 80(8), he can, under subsection 80(9), apply an amount of $7,000 to reduce to $0 the ACB of his interest in the partnership. An amount of $4,000 (50% × $8,000) must be added to his income under subsection 80(13) in computing his income for the 2008 taxation year. Alternatively, Ken could claim a deduction for a reserve under section 61.2.

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In addition, subsection 80(18) applies where a commercial obligation issued by a partnership is settled. The partnership cannot indicate amounts under subsections 80(9), 80(10), and 80(11) so that the ACB of a property at the time of settlement will be less than its FMV at that time. This measure is intended to prevent a partnership from acquiring capital properties to lessen the impact of section 80. This measure is limited to partnerships because many tax attributes, such as loss carryforwards, are allocated to members and the forgiveness of a commercial obligation that is considered to have been issued by a partnership does not result in a reduction of those attributes, subject to the application of subsection 80(15).

LEVEL 1

## Charitable gifts

Charitable gifts made by the partnership are considered to be gifts made by the partners, and thus must be added back to the net income of the partnership before being allocated to the partners based on their respective share of the partnership, under subsection 110.1(4) in the case of a corporation and subsection118.1(8) in the case of an individual.

The usual rules then apply to the partner. If the partner is an individual, for example, he is entitled to a tax credit under subsection 118.1(3). The amount of charitable gifts claimed by the partner is then limited to 75% of the partner's net income under subsection 118.1(1).

## Political contributions

Similar to charitable gifts, political contributions made by the partnership are added back to the partnership's net income, then allocated to partners according to their respective share. Under subsection 127(4.2), this share is added to the political contributions made by the partner and the tax credit for political contributions is computed on this total.

## Foreign tax credit

If a partnership pays income taxes to a foreign country, such as withholding tax on American dividends, the partners are deemed to have paid their share of these income taxes and may claim a foreign tax credit under section 126.

## Expenses incurred personally by the partners

A partnership agreement may require that certain expenses incurred by a partner, such as automobile expenses and entertainment costs, are to be paid by the partner personally. The partner may deduct such expenses to the extent that they are incurred in earning the partnership income. The administrative position is that partners may deduct those expenses incurred in the partnership's fiscal year.

This administrative policy does not apply to interest expense that is deductible under paragraph 20(1)(c) on money borrowed by a partner to acquire an interest in a partnership. Interest expense is deductible in the year in which it is paid or payable depending on the method regularly followed by the partner.

## Non-resident partners

Due to the many restrictions and requirements (such as Part XIII withholding tax) which apply to a partnership having a non-resident member, most partnership agreements provide that a non-resident cannot become a member of the partnership. Where a resident partner becomes non-resident, the partnership agreement may provide that he must sell his interest prior to his departure. The tax consequences of a non-resident holding an interest in a partnership are not covered by this course.

## Transfer of property to partners

Subsection 98(2) provides that when a partnership disposes of property to a partner, the disposition is deemed to take place at FMV and the partner is deemed to have acquired the property at FMV. This rule applies whether or not the partner has a majority interest. The disposition at FMV will result in income, a loss, a recapture of CCA, or a capital gain or loss that must be taken into account when computing income for the year of the disposition. There are exceptions to this rule when a partnership ceases to exist, and these will be examined further on in this module.

# Computation of the ACB of a partnership interest

LEVEL 1

Since a partnership interest represents capital property (the gain or loss from the disposition of which would be a capital gain or a capital loss), the ACB must be determined for each total or partial disposition.

The ACB may be the partner's capital in the partnership. However, it will be different from the partner's accounting capital if the interest was acquired from another partner, for a price that is different from the share of the partnership capital attributed to him, or where the partner was a member of the partnership on December 31, 1971, or where the accounting income or loss is different from the income or loss attributed for tax purposes.

## Interest acquired after 1971

Where the partnership interest was acquired after 1971, the ACB of the interest is equal to the acquisition cost plus the items that must be added under subsection 53(1) and less those that must be deducted under subsection 53(2). Some of these items affect the ACB of the interest during the fiscal period of the partnership, while others do so only at the end of the fiscal period. These differences can cause problems when a partner leaves the partnership.

The main amounts to be added under paragraph 53(1)(e) are

- the partner's share of the net income of the partnership for each fiscal period of the partnership ending before the computation is made (other than a share of income paid to a retired partner), computed as follows:

  (i) taking into account 100% of the income arising from the disposition of an ECP

  (ii) taking into account 100% of the partnership's capital gains

  (iii) not taking into account the following items:

  - 55: avoidance of income tax on a capital gain
  - 82(1)(b): gross-up on dividends from taxable Canadian corporations

  In *Technical News No. 5,* published on July 28, 1995, CRA states that when calculating the ACB of a partner's partnership interest, only the partnership income for fiscal periods already ended will be taken into account. Thus, the partner's share of the partnership income for the fiscal period in question will give rise to an addition to the ACB of the interest after the end of that fiscal period. The legislative proposals of October 27, 2007 contain changes regarding this. The share of the partnership income for the year in which the partner ceases to be a member would be added to the ACB of the interest in the partnership during that fiscal period. This would improve some cases in which a former partner is in a double taxation situation or is required to report during the year in which he left the partnership a capital gain that is offset by a capital loss in a subsequent year. The proposed amendments are **not examinable.**

- the partner's share of any capital dividend received by the partnership. This amount is added during the fiscal period, that is, at the time it is received by the partnership;
- the partner's share of the excess of the proceeds of a life insurance policy received in consequence of the death of the insured over the ACB of the policy; this amount is added to the ACB at the time it is received;

- a contribution of capital to the partnership by the partner that cannot reasonably be considered as a gift made to another member of the partnership who was related to the partner; this amount is added to the ACB at the time it is received by the partnership; loans to the partnership are not considered to be contributions of capital to the partnership;
- the amount that is deemed by subsection 40(3.1) to be a gain for the partner for a taxation year, resulting from the disposition of the interest prior to that time;
- the amount included in the income of a deceased partner as rights or things under subsection 70(2), being his share of the income earned to the date of death where the partnership does not cease to exist following death. However, this amount does not include the share of income of a retired partner;
- the amount deemed to be a capital gain arising from a negative ACB under paragraph 98(1)(c) or 98.1(1)(c), where a partnership ceases to exist or an associate withdraws;
- the partner's share of any government assistance or grant received with respect to a resource property or an exploration or development expense incurred in Canada;
- the amount required by section 97 to be added to the ACB following the transfer of property to the partnership.

The main amounts to be deducted under paragraph 53(2)(c) are:

- the partner's share in the losses of the partnership for each fiscal period of the partnership ending before the date of computation (other than a loss attributed to a retired partner), computed as follows:

  (i) taking into account 100% of the terminal loss arising from the disposition of an ECP

  (ii) taking into account 100% of the partnership's capital losses

  (iii) not taking into account the following items:

    - 40(2): loss deemed to be nil
    - 31: restricted farm loss
    - 112(3.1): loss reduced if due to payments of dividends

The comments contained in *Technical News No. 5* concerning the time at which the partnership income affects the calculation of the ACB of an interest, mentioned above, also apply to the loss from a partnership:

- the amount deemed by subsection 40(3.12) to be a loss for the partner for a taxation year, resulting from the disposition of the interest prior to that time;
- the amount of deductions, for each fiscal period ending before the computation, relating to exploration and development expenses under subparagraph 53(2)(c)(ii);
- for each fiscal period ending before the computation, any amount deemed by subsection 118.1(8) to be a gift made by a partner and any amount deemed by subsection 127(4.2) to have been a political contribution made by the partner; these amounts are deducted from the ACB at the end of the fiscal period;
- the amount required by section 97 to be deducted from the ACB on the transfer of property to the partnership;
- the amount of capital withdrawals made by the partner before the computation (other than income paid to a retired partner);
- an amount equal to the investment tax credit *deducted* by the partner under subsection 127(8) relating to an investment made by the partnership;

- the amount representing the portion of the ACB relating to a partial disposition;
- the amount of all assistance received that has resulted in a reduction of the capital cost of a depreciable property by virtue of subsection 13(7.2);
- an amount deductible by the partner under subparagraph 20(1)(e)(vi) following the dissolution of the partnership, such as that portion of the costs of borrowing money, deductible at the rate of 20% per year, which had not been deducted by the partnership at the time of its dissolution.

Example 7-7 illustrates how the ACB of a partnership interest is computed.

EXAMPLE 7-7

Alma Harrison has a 40% interest in the partnership Express whose fiscal period ends on December 31, 2008. The ACB of Alma's interest as at January 1, 2008, was $40,000.

The following is a summary of the transactions of Express for 2008:

| | |
|---|---|
| Net business income [1] | $ 52,000 |
| Capital gain (100%) | $ 18,000 |
| Taxable dividends received | $ 12,000 |
| Gross foreign income | $ 2,000 |
| Dividends from a CDA | $ 8,000 |
| Capital contribution by Alma | $ 10,000 |
| Withdrawals by Alma | $ 27,000 |
| Capital loss (100%) | $ 10,000 |
| Charitable gifts | $ 3,000 |
| Political contributions | $ 700 |

Computation of the ACB of Alma's interest as at January 1, 2009:

| | | | |
|---|---|---|---|
| ACB as at January 1, 2008 | | | $ 40,000 |
| Add: 53(1)(e) | | | |
| (i) | Share of partnership income | | |
| | Business income (40% × $52,000) | $ 20,800 | |
| | Capital gain (40% × $18,000) | 7,200 | |
| | Taxable dividends (40% × $12,000) | 4,800 | |
| | Gross foreign income (40% × $2,000) | 800 | 33,600 |
| (ii) | Dividends from a CDA (40% × $8,000) | | 3,200 |
| (iv) | Capital contribution | | 10,000 |
| | | | 86,800 |
| Deduct: 53(2)(c) | | | |
| (i) | Capital loss (40% × $10,000) | | (4,000) |
| (iii) | Charitable gifts (40% × $3,000) | $ 1,200 | |
| | Political contributions (40% × $700) | 280 | (1,480) |
| (v) | Withdrawals | | (27,000) |
| ACB as at January 1, 2009 | | | $ 54,320 |

[1] Charitable gifts and political contributions are not included in the net business income of $52,000. Therefore, these two items are not added to business income in computing the ACB of Alma's interest.

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## Negative ACB

Under paragraph 40(3)(a), the general principle contained in subsection 40(3) under which a negative ACB is considered to be a capital gain in the year does not apply to partnership interests. In fact, paragraph 40(3)(a) excludes deductions made under paragraph 53(2)(c) which is the provision for reducing the value of the partnership interest's ACB as studied earlier in this topic. The capital gain evidenced by a negative ACB is realized only on the disposition of the partnership interest (*inter vivos* or on death). However, exceptions are provided for, in the case of certain interests held in a limited partnership or a non-excluded corporation.

# Transfer of property to the partnership and admission of a new partner

LEVEL 1

## Formation of a partnership

On the formation of a partnership, certain property, such as a contribution of cash, may be transferred to the partnership by its members. A member's original cost of the partnership interest is dependent on the property transferred and the method of transfer.

If the contribution is in the form of cash, the amount invested represents the original cost of the interest; if the contribution is in the form of property, the transfer must take place at FMV in accordance with section 69 and subsection 97(1). Such a transfer may result in tax consequences for the members, such as a capital gain or loss, a recapture of CCA or a terminal loss and, in the case of a professional, the taxation of work-in-progress. Where the contribution of a partner consists of his knowledge and experience, the ACB of his interest is deemed to be nil.

The tax authorities, recognizing that a taxpayer may wish to change the legal structure of his enterprise, have provided rules that allow the tax consequences on the transfer of assets to be deferred. These rules are called the **rollover** rules. The rules applicable on the transfer of property to a partnership are similar to provisions contained in section 85 for the transfer of property to a corporation.

## Rollover on the transfer of property to a partnership

The rollover rules contain conditions and limitations that must be met if the transfer is to be accomplished tax-free. For information on this subject, read IT-413R. Rollover rules are often useful in the formation of a partnership but may also apply to any transfer of property to the partnership.

Subsection 97(2) requires that the following conditions be met:

- The partnership must be a Canadian partnership as outlined in section 102 immediately after the transaction (transfer of property to the partnership). A Canadian partnership is a partnership of which all the members are resident in Canada.
- The taxpayer transferring the property must be a member of the partnership immediately after the transaction.
- The taxpayer and all other members of the partnership must jointly make an election using Form T2059, "Election on Disposition of Property by a Taxpayer to a Canadian Partnership."
- Under subsection 96(4), Form T2059 must be filed by **the first member of the partnership** who is required to file his income tax return for the taxation year in which the transaction to which the election relates occurred. Thus, by virtue of subsection 96(3), this member makes the election on behalf of all the others. The year end of the partnership is not a factor to be considered in determining the date for filing Form T2059.

If the members of the partnership are all individuals, the filing date is June 15 of the year following the disposition. If, however, one or more members are corporations, closer attention must be paid to the filing date.

EXAMPLE 7-8

Celco Ltd. and Deluxe Ltd. are members of a partnership.

| | **Year end** |
|---|---|
| Celco Ltd. | March 31 |
| Deluxe Ltd. | December 31 |
| Partnership | January 31 |

On April 27, 2008, Celco Ltd. transfers a capital property to the partnership using the election under subsection 97(2).

The transfer occurred during the fiscal period ending March 31, 2009, for Celco Ltd. and during the fiscal period ending December 31, 2008, for Deluxe Ltd. The income tax return of Celco Ltd. must be filed no later than September 30, 2009, and that of Deluxe Ltd., no later than June 30, 2009.

Form T2059 must be filed no later than June 30, 2009, being the date by which Deluxe Ltd. must file its income tax return. Deluxe Ltd. is the first member of the partnership to file its income tax return for the taxation year in which the election under subsection 97(2) took place.

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Under subsection 96(5), CRA allows a late election to be filed. The election will be accepted provided it is filed within three years from the prescribed date, being the date on which it should have been filed, and the penalty provided in subsection 96(6) is paid. The penalty is equal to: 1/4 of 1% of the excess of the FMV of the property transferred over the agreed amount. However, the penalty cannot exceed the lesser of $8,000 and $100 per month or part of a month for which the election is late. An election may also be filed after the three-year period under subsection 96(5.1) where, in the opinion of the Minister, it is just and equitable to permit the taxpayer to file the election after this period and the penalty is paid. An amended election may also be accepted by the Minister if it is filed on Form T2059 and the penalty is paid. The late election rules are similar to those regarding the transfer of property to a corporation.

Effecting a rollover means, for tax purposes only, that the POD will be deemed equal to the agreed amount, as in the case of a rollover using the provisions of section 85.

Subsection 97(2), which refers to paragraphs 85(1)(a) to (f), requires that the following limits be respected:

- The agreed amount cannot exceed the FMV of the property transferred and cannot be less than the FMV of any consideration received other than a partnership interest.
- For non-depreciable capital property or inventory, the agreed amount cannot be less than the lesser of the FMV or the cost amount of the property, as defined in subsection 248(1).
- For ECPs, the agreed amount cannot be less than the lesser of the FMV of the eligible capital property (ECP) or 4/3 of the cumulative eligible capital (CEC). The agreed amount cannot be nil; a value of $1 should be stated, such as for goodwill, which would have a value but which would have had a nil cost.
- For depreciable property, the agreed amount cannot be less than the least of:

  1. UCC of the class in which the property is included
  2. FMV of the property

  or

  3. CC of the property

- Where more than one depreciable property or ECP is transferred, the order of transferring the property must be specified to avoid any recapture of CCA. If no order is specified, the Minister may designate an order for the items of depreciable property transferred using the reference to paragraph 85(1)(e.1). The ordering as designated by the Minister may not be advantageous.
- Where the FMV of the property transferred is greater than both the FMV of the consideration received, including the partnership interest, and the agreed amount and it is reasonable to consider any part of the excess as a benefit conferred on a related person, the agreed amount is increased by the amount of the benefit. The deemed POD are therefore greater for the vendor.

The agreed amount is the taxpayer's (vendor's) POD and the partnership's cost.

The cost of property received by the vendor taxpayer as consideration, other than his partnership interest, is equal to its FMV. The ACB of the vendor's interest in the partnership is determined under paragraph 97(2)(b):

- If the agreed amount exceeds the FMV of the consideration received, other than the partnership interest, the excess is added to the ACB of the vendor's interest.
- If the FMV of the property transferred is less than the FMV of the consideration received, other than the partnership interest, the difference reduces the ACB of the vendor's interest.

Unlike section 85, which requires that at least one share or a portion of a share be issued on a rollover, a transfer under subsection 97(2) may be made without an interest in the partnership being acquired as a result of this transaction. However, it should be kept in mind that the transferor must be a member of the partnership immediately after the transaction. Therefore, only a person who was a partner before the transaction can effect a rollover without acquiring an additional interest in the partnership. Since that partner already has an interest in the partnership, the transaction may affect the ACB of his interest as described above.

Example 7-9 shows the tax consequences in four unrelated situations when property is transferred to a partnership.

EXAMPLE 7-9

| | **Dick Hall** | **Luc Dubois** | **Ann Fong** | **Lisa Lee** |
|---|---|---|---|---|
| FMV of the property transferred | $ 15,000 | $ 15,000 | $ 10,000 | $ 10,000 |
| Cost amount of the property transferred | $ 12,000 | $ 12,000 | $ 12,000 | $ 12,000 |
| Agreed amount | $ ? | $ ? | $ ? | $ ? |
| Consideration received from the partnership, other than the partnership interest | $ 12,000 | $ 9,000 | $ 9,000 | $ 10,000 |
| FMV of the interest in the partnership | $ 3,000 | $ 6,000 | $ 1,000 | — |
| ACB of the partnership interest | — | $ 3,000 | $ 1,000 | — |

The agreed amount (and therefore the POD for the member and the acquisition cost for the partnership) would be:

Dick: $12,000, the cost amount. The portion allocated to the acquisition cost of the interest is nil.

Luc: $12,000, the cost amount. An amount of $3,000 is added to the acquisition cost of the interest.

| | |
|---|---|
| Ann: | $10,000, because the agreed amount cannot be greater than the FMV of the property transferred. An amount of $1,000 is added to the acquisition cost of the interest. |
| Lisa: | $10,000, because the FMV of the property transferred is only $10,000 and the agreed amount cannot be greater than the FMV of the property transferred. The portion allocated to the acquisition cost of the interest is nil. |

---

Where an individual who holds a majority interest transfers property to the partnership and incurs a capital loss, the loss is considered to be a superficial loss as defined in section 54. Under subparagraph 40(2)(g)(i), a superficial loss is considered to be nil and the amount of the loss is added to the ACB of the property acquired by the partnership under paragraph 53(1)(f). If the transferor is a corporation, a partnership or a trust, the provisions of subsection 40(3.3) apply.

For the loss to be considered a superficial loss, the disposition must, among other things, be made to an affiliated person. In the case of a partner and the partnership, they are affiliated persons under paragraph 251.1(1)(e) if the partner holds a majority interest in the partnership.

The definition of a majority interest partner is contained in subsection 248(1). It applies on the basis of the entitlement of a member of the partnership to the partnership's income from all sources. Thus, a person or partnership is considered to be a majority interest partner if at any given time that person or partnership is entitled to more than half of the partnership's income from all sources for the preceding fiscal period. This is also the case where the partner was entitled to more than half of the amount paid to all members of the partnership if the partnership was wound up at that time. For the application of this definition, the partner is considered to hold each interest that an affiliated person holds in the partnership.

Example 7-10 provides an illustration of a superficial loss with a majority interest partner.

EXAMPLE 7-10

---

Albert Laplante owns a 70% interest in the partnership Piccolo. He transfers a non-depreciable capital property to Piccolo under subsection 97(2).

| | |
|---|---|
| FMV of the property transferred | $ 15,000 |
| ACB | $ 17,000 |
| Agreed amount | $ 15,000 |
| Cash consideration/FMV | $ 15,000 |

***Tax consequences***

1. For Albert:

| | |
|---|---|
| POD (agreed amount) | $ 15,000 |
| ACB | (17,000) |
| Capital loss | $ (2,000) |

Under section 54, the capital loss of $2,000 is a superficial loss, since Albert has a 70% interest in Piccolo. It is therefore deemed to be nil under subparagraph 40(2)(g)(i).

2. For Piccolo:

Under paragraph 53(1)(f), the amount of the loss is added to the cost of the property acquired, namely $17,000.

---

Once a partnership has acquired a depreciable property from a partner, the partnership is deemed to replace the partner for purposes of any potential recapture of CCA if the capital cost exceeds the POD. Under subsection 97(4), the partnership is deemed to have a capital cost equal to the partner's capital cost and to have claimed the difference between the capital cost and the agreed amount (POD) as CCA.

Since the purpose of a rollover is generally to defer taxation of a capital gain and/or CCA recapture, clauses on this subject may be included in the partnership agreement. One such clause might provide that when property transferred to the partnership by a partner is later disposed of by the partnership, the portion of the capital gain and/or CCA recapture that was deferred may be allocated solely to the partner who made the transfer. In that case the other partners would not be taxed on the capital gain and/or CCA recapture that was deferred.

For a disposition of property after December 20, 2002, it is proposed that capital gains reserves no longer be available where the purchaser of the property is a partnership and the vendor is a partner holding a majority interest.

The proposed amendments are **not examinable**.

## Admission of a new partner

In certain circumstances, the arrival of a new partner may prompt the dissolution of the partnership. The partnership may have to be wound up unless the partnership agreement provides that the partnership is not dissolved on the admission of a new partner. The tax consequences of the admission of a new partner will differ depending on the method used to admit the new partner.

1. If a new partner acquires his interest from one or more partners, those partners will be deemed to have disposed of a portion of their interest for a POD equal to the consideration received from the new partner. A capital gain or loss may result. Example 7-11 illustrates this principle.

EXAMPLE 7-11

Susan Chan owns a 60% interest in a partnership. Her ACB is $100,000. On the arrival of a new partner, she disposes of a 10% interest of the total partnership, which equals 1/6 of her interest, for $25,000.

| | |
|---|---|
| POD | $ 25,000 |
| ACB (1/6) × $100,000 | (16,667) |
| Capital gain | $ 8,333 |
| | |
| Taxable capital gain (1/2) | $ 4,167 |

After the disposition, the ACB of Susan's interest is as follows:

| | |
|---|---|
| ACB before the disposition | $100,000 |
| Reduction of the ACB | (16,667) |
| ACB after the disposition | $ 83,333 |

2. Where a new partner acquires his partnership interest by contributing capital to the partnership, the other partners are not deemed to have disposed of a portion of their interest and no adjustment is required to their ACB.

The ACB of the new partner's interest is equal to the FMV of the asset contributed (cash or other) or is based on the agreed amount determined under subsection 97(2). If the new partner makes a contribution other than in kind or cash (his experience, for example), the acquisition cost of his interest is deemed to be nil.

# READING 7-5

# Withdrawal of a partner

LEVEL 1

The withdrawal of a partner results in a disposition of the partnership interest for that partner. In certain circumstances, the partnership agreement may provide that, on the withdrawal of a partner, the remaining partners will allocate a portion of future income to the retired partner. The retiring partner may also retain a residual interest.

## Consequences for the partnership

The withdrawal or death of a partner may lead to the wind-up of the partnership with all the related tax consequences. However, partnership agreements usually provide that the partnership will continue to exist even if a member retires or dies, because the practical consequences would be too detrimental if a winding-up were to arise every time a partner withdrew. If the partnership is wound up on the retirement or death of one of its members, a new partnership of old members may be formed, thereby avoiding most of the tax consequences. Under subsection 98(6), this new partnership will be deemed to be a continuation of the old partnership. This rollover rule, therefore, avoids a disposition of property for the partnership and a disposition of the partnership interest for the partners.

In order for the rollover rules to apply, the following conditions must be met:

- The former partnership and the new partnership must be Canadian partnerships, that is, all the partners must be resident in Canada.
- The former partnership must have ceased to exist.
- All the property of the former partnership must have been transferred to the new partnership. However, CRA considers that all the property has been transferred even if a portion of the property is distributed to the withdrawing partner in settlement of his interest.
- Only members which were members of the former partnership may be members of the new partnership. This condition appears to be required only at the time of transfer. A new partner could be admitted after all the conditions have been met and the rollover accepted. All the members of the former partnership are not required to be members of the new partnership. If some members withdraw, the percentage of the interest in the new partnership may be different from that of the former partnership.

There is no prescribed form to be filed for this rollover to apply. The rollover automatically applies when the above conditions are met.

## Consequences for the retired partner

When a partner withdraws from the partnership, he may sell his interest to another partner or to a third party, or have his interest redeemed by the partnership.

If the partner disposes of his interest through a sale, he is subject to the usual rules for computing capital gains and losses. However, if the interest is redeemed by the partnership, under paragraph 98.1(1)(b), the retired partner is not deemed to have disposed of his interest until the end of the fiscal period of the partnership and the provisions of the ITA regarding residual interests apply.

Where property has been distributed to the partner as a return of capital, the partnership is deemed to have disposed of such property at its FMV. This may give rise to a capital gain or loss, or a recapture of CCA, or a terminal loss for the partnership. The retired partner is

required to reduce the ACB of his partnership interest by an amount equivalent to the FMV of the property received. Example 7-12 illustrates the tax consequences when a partner departs.

EXAMPLE 7-12

Alice Bergeron, a member of a partnership, decides to retire. In settlement of her interest, she receives land (capital property) from the partnership having an FMV of $50,000. The ACB of the land for the partnership is $10,000 and the ACB of Alice's partnership interest is $40,000.

***Tax consequences***

1. For the partnership:

| | |
|---|---|
| POD of the land | $ 50,000 |
| ACB of the land | (10,000) |
| Capital gain | $ 40,000 |

2. For Alice:

| | |
|---|---|
| ACB of the partnership interest | $ 40,000 |
| Reduction — FMV of the land | (50,000) |
| Negative ACB | $ (10,000) |
| Capital gain | $ 10,000 |
| Taxable capital gain (1/2) | $ 5,000 |

Where a taxpayer has ceased to be a member of a partnership during a fiscal period and, before the end of the fiscal period, he has received all the property from the partnership to which he is entitled as consideration for the disposition of his partnership interest, the taxpayer is deemed not to have disposed of his interest until the end of the fiscal period. The deferral of the disposition is required because, under section 53, the ACB is increased only for the share of partnership income for complete years ending before the date of disposition.

LEVEL 2

## Residual interest in a partnership

Sometimes, the retired partner does not receive complete payment for all his rights arising from the partnership, representing his capital contribution, his share of reinvested profits and any additional amount provided for under the agreement, before the end of the fiscal period of the partnership. In such a case, he is deemed not to have disposed of his partnership interest and, under paragraph 98.1(1)(a), holds a residual interest. A residual interest is not the same as being a partner, and paragraph 98.1(1)(d) specifically states that, where a taxpayer has a residual interest, he is deemed not to be a member of the partnership except for limited circumstances. Even if the partnership is dissolved thereafter, the retired partner can maintain a residual interest if the members of another partnership agree to satisfy his rights as stipulated in subsection 98.1(2).

A residual interest is considered to be a continuation of the taxpayer's interest. The ACB of the residual interest is equal to the ACB of the partnership interest immediately prior to retirement (IT-242R). The adjustments provided in section 53 applicable to a partnership interest apply to the residual interest. However, under paragraph 98.1(1)(c), where at the end of the fiscal period of the partnership, the ACB of the residual interest is negative, the retired partner is required to report a capital gain equal to the negative amount; his ACB is then reduced to zero. Under this provision, the partner who withdraws from the partnership and whose partnership interest is redeemed by the partnership may recover an amount corresponding to the ACB of his interest tax-free before being subject to tax on a capital gain.

However, the retired partner may only deduct a capital loss on his retirement once all of his rights have been settled. This capital loss is equal to the positive amount of the ACB of his interest once all adjustments have been made.

The settlement of the residual interest may take several years or may be completed before the end of the fiscal year of the partnership in which the partner retired. If he settles before the end of the fiscal year, under paragraph 98.1(1)(b), the retired partner is deemed to have disposed of his residual interest at the end of the fiscal year of the partnership. In some circumstances, this enables the retired partner to defer, by one taxation year, the taxation of the capital gain on the disposition of his interest in the partnership. This is illustrated in Example 7-13.

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EXAMPLE 7-13

Felix Martin is a member of the Dendrite partnership whose fiscal period ends on January 31. He decides to retire on July 31, 2008. On February 1, 2008, the ACB of his interest was $150,000. Under the partnership agreement, Felix is entitled to receive $180,000 for his interest.

***Tax consequences***

1. If paragraph 98.1(1)(b) did not apply, Felix would be in the following situation:

| | |
|---|---|
| POD | $ 180,000 |
| ACB | (150,000) |
| Capital gain | $ 30,000 |
| | |
| Taxable capital gain (1/2) | $ 15,000 |

   An amount of $15,000 should be included in Felix's income for 2008.

2. If paragraph 98.1(1)(b) applied, Felix would include $15,000 of capital gain in his income for 2009, since he will be deemed to have disposed of his residual interest only at the end of Dendrite's fiscal period, namely, January 31, 2009.

---

If the amount is substantial, the settlement of the rights may be carried out over a longer period. This method may be less onerous for the remaining partners. For the retired partner, this method may defer tax on the capital gain, because he will be taxed only when the ACB of his interest becomes a negative amount.

Example 7-14 shows the tax consequences for a retired partner depending on whether or not he retains a residual interest.

---

EXAMPLE 7-14

MacKay Inc. is a member of the Zircon partnership whose fiscal period ends on December 31. On March 4, 2008, MacKay Inc. withdraws from the partnership. It may either sell its interest to the remaining partners or have its interest settled by the partnership. In both cases, MacKay Inc. will receive $25,000 payable as follows: $10,000 in cash and $15,000 on March 1, 2009. The ACB of MacKay Inc.'s interest on January 1, 2008, is $5,000. All members of the partnership are corporations.

***Tax consequences for MacKay Inc.***

1. If the remaining partners purchase MacKay Inc.'s interest:

<u>2008</u>

| | |
|---|---:|
| POD | $ 25,000 |
| ACB | (5,000) |
| Capital gain | 20,000 |
| Reserve [40(1)(a)(iii)]: the lesser of: | |
| • 4/5 of $20,000 = $16,000 | |
| • $\frac{\$20,000}{\$25,000} \times \$15,000 = \$12,000$ | (12,000) |
| Capital gain | $ 8,000 |
| Taxable capital gain (1/2) | $ 4,000 |

<u>2009</u>

| | |
|---|---:|
| 2008 reserve | $ 12,000 |
| 2009 reserve: the lesser of: | |
| • 3/5 of $20,000 = $12,000 | |
| • $\frac{20,000}{\$25,000} \times \$0 = \$0$ | — |
| Capital gain | $ 12,000 |
| Taxable capital gain (1/2) | $ 6,000 |

2. If the partnership settles the interest:

<u>2008</u>

MacKay Inc. must declare income in 2008 because the withdrawal would have taken place during the fiscal period ending December 31, 2008. It will be taxed on a capital gain in 2008, because the ACB of its residual interest becomes a negative amount.

| | |
|---|---:|
| ACB as at January 1, 2008 | $ 5,000 |
| Amount withdrawn on March 4, 2008 | (10,000) |
| ACB as at December 31, 2008 | $ (5,000) |
| Capital gain | $ 5,000 |
| Taxable capital gain (1/2) | $ 2,500 |

<u>2009</u>

| | |
|---|---:|
| ACB as at December 31, 2008 | $ (5,000) |
| Adjustment [53(1)(e)(vii)] | 5,000 |
| | — |
| Amount withdrawn on March 1, 2009 | (15,000) |
| ACB as at December 31, 2009 | $ (15,000) |
| Capital gain | $ 15,000 |
| Taxable capital gain (1/2) | $ 7,500 |

As seen in this example, following a settlement from the partnership, tax on a larger portion of MacKay Inc.'s capital gain was deferred to 2009.

---

The retired partner is not deemed by the ITA to have carried on a business in Canada. Therefore, the retired partner is not eligible to use the alternative method of computing business income.

## Income interest in the partnership

Sometimes, partners agree to allocate to a retired partner or a deceased partner's estate a share of future partnership income. For example, this payment may represent a pension.

For purposes of sharing the net income, the retired partner or the estate is deemed to continue to be a member of the partnership. Under paragraph 96(1.1)(b), the amount allocated to the retired partner or the estate is included in his income for the taxation year in which the fiscal period of the partnership ends, regardless of when received. This amount is excluded from the income share allocated to the other partners.

For this agreement to be acceptable by the tax authorities, certain conditions set out in paragraph 96(1.1)(a) must be met:

- The principal activity of the partnership must be the carrying on of a business in Canada.
- The partners must have entered into an agreement to allocate a share of the income or loss of the partnership to the partner.
- The taxpayer must cease to be a member of the partnership.

Under the agreement, a share of the income or loss must be allocated to the retired partner or his estate. The amount allocated may be a fixed annual amount or computed as a percentage of the net income or may relate to some classes of income only or may provide for the allocation of income but not losses.

Under subsection 96(1.4), the rights of a partner or estate in the partnership income is deemed not to be capital property or a residual interest. On disposition of this right, the POD are considered to be business income under paragraph 96(1.2)(a).

Where a partner acquires a "share of the income of the partnership," he is entitled to a deduction for the cost of acquiring the share under subsection 96(1.3). The amount of the deduction is equal to the cost of the right less amounts deducted in previous years. This deduction cannot exceed the amount included in income.

Under subsection 96(1.6), a taxpayer who is deemed by paragraph 96(1.1)(a) to be a member of a partnership which carries on a business in Canada will himself be deemed to carry on a business in Canada for the purposes of sections 34.1 and 34.2. Therefore, the retired partner who retains an income interest in the partnership or the estate is eligible to use the alternative method of computing business income. However, such income is not considered "earned income" for purposes of calculating possible contributions to an RRSP.

## Consequences for a deceased partner

The death of a taxpayer gives rise to a deemed disposition of his interest in the partnership or his residual interest for proceeds equal to FMV.

Under section 98.2 and subsection 100(3), the beneficiaries of the estate, if they cannot become members of the partnership, will be deemed to have acquired a "right to receive partnership property" (and not an interest) at a cost equal to the FMV of the interest at the time of death. This right will be considered to be capital property for the beneficiaries. Amounts received from the partnership in settlement of this right will reduce the ACB of the property; if the amounts received exceed the ACB of the right, the excess will be deemed to be a capital gain.

# READING 7-6

## Dissolution of a partnership

LEVEL 1

### Undivided interest

With certain exceptions, subsection 98(2) provides that, on distribution of partnership property to a partner, the transfer is deemed to take place at FMV. Then, the partner is deemed to have acquired the property at FMV. Under subsection 98(1), when the partnership ceases to exist, the ACB of the partnership interest is reduced by the FMV of the property received and it could result in a capital gain if the ACB of the partnership interest becomes negative. However, under subsection 98(3), partnership property may be transferred to the members tax-free if the partnership makes an election.

Certain conditions must be met under subsection 98(3):

- The partnership must be a Canadian partnership.
- The partnership must have ceased to exist.
- All of the partnership property must have been distributed to persons who were members of the partnership immediately before it ceased to exist.
- Immediately after the dissolution, each such person must *have an undivided interest in each property distributed.* Each partner's undivided interest in each property distributed must be equal.
- A joint election must be filed by all the partners in prescribed form (Form T2060) within the time limit referred to in subsection 96(4). Form T2060 must therefore be filed no later than the date on which the first member of the partnership must file his income tax return for the taxation year during which the election occurs.

Where all the conditions are met, the following tax consequences arise upon dissolution:

- The partnership is deemed to have disposed of all its property for proceeds equal to the cost amount of such property immediately before the dissolution. There will be no gain or loss on the dissolution.

- Under paragraph 98(3)(a), each partner is deemed to have disposed of his partnership interest for an amount equal to the greater of

  (i) the ACB of his partnership interest
  (ii) the amount of any money received on the dissolution plus his percentage of the cost amount defined in subsection 248(1) of all the property distributed

  To the extent that the amount in (ii) is less than the ACB of the interest, there will be no gain or loss. However, if the amount in (ii) exceeds the ACB of the interest, a capital gain will be realized.

  The ITA does not take into account the partnership's liabilities. They must be repaid before the dissolution or be assumed by the partners. In the latter case, the assumption of liabilities is considered to be a contribution of capital that increases the ACB of the interest.

- Where the POD determined above are equal to the ACB of the interest, and this amount exceeds the total of the amount of money received and the percentage of the total cost amount of the property distributed, under paragraph 98(3)(b), the difference may be added to the cost of capital property received, other than depreciable property. However, after such addition, the cost to the partner may not exceed his undivided interest in the FMV of the property.

- The amount of recaptured CCA that could have been realized by the partnership on the disposition of depreciable property is transferred to the partner under paragraph 98(3)(e). Where the partner's undivided interest in the partnership's original cost of the depreciable property distributed to the partner exceeds his cost of the property, he will be deemed to have a capital cost equal to his undivided interest in the partnership's original capital cost and to have claimed the difference between the two amounts as CCA. Therefore, on a subsequent disposition, a partner may be subject to tax on the recapture of CCA deducted by the partnership.
- Subsection 98(3) does not apply, according to the rules of subsection 98(4), where the business is continued by a single partner or where there is a dissolution of the partnership following a rollover of property to a corporation.

Example 7-15 illustrates how subsections 98(2) and (3) apply.

EXAMPLE 7-15

---

Alex Gordon and Janine Lacombe carried on a business in a partnership until 2008. Following the sale of most of the business assets, only the following assets were left in the partnership:

| | **FMV** | **Cost** | **UCC** |
|---|---|---|---|
| Land | $ 50,000 | $ 20,000 | — |
| Building | $200,000 | $140,000 | $100,000 |

Alex and Janine each have a 50% interest in the partnership and the ACB of their interests are

| | |
|---|---|
| Alex | $105,000 |
| Janine | $ 40,000 |

Alex and Janine decide to wind-up the partnership at year end, being May 31, 2008, and to personally own an undivided interest in the building, which they will rent out in the future. Assume that the income of the partnership is nil for the 2008 fiscal year and that the partnership has no liabilities at that time.

***Tax consequences***

1. If no election is made:

   a. For the partnership:

      Disposition of property at FMV [98(2)]

| | |
|---|---|
| Land | |
| FMV | $ 50,000 |
| ACB | (20,000) |
| Capital gain | $ 30,000 |
| Taxable capital gain (1/2) | $ 15,000 |
| Building | |
| FMV | $200,000 |
| Capital cost | (140,000) |
| Capital gain | $ 60,000 |
| Taxable capital gain (1/2) | $ 30,000 |

| | | |
|---|---|---|
| Recapture of CCA | | |
| The lesser of: | | |
| • cost | $ 140,000 | |
| • POD | $ 200,000 | $140,000 |
| Less: UCC | | (100,000) |
| | | $ 40,000 |

b. For Alex and Janine:

| | Alex | Janine |
|---|---|---|
| Acquisition cost of the property | | |
| Land (50% undivided) | $ 25,000 | $ 25,000 |
| Building (50% undivided) | $ 100,000 | $100,000 |
| Income from the partnership | | |
| • taxable capital gain | | |
| land | $ 7,500 | $ 7,500 |
| building | 15,000 | 15,000 |
| • recapture of CCA | 20,000 | 20,000 |
| | $ 42,500 | $ 42,500 |
| ACB of the partnership interest | | |
| Balance at the beginning of year (does not take into account the income for the year) | $ 105,000 | $ 40,000 |
| 100% of capital gains ($15,000 + $30,000) | 45,000 | 45,000 |
| Recapture of CCA | 20,000 | 20,000 |
| Balance on the winding-up | $ 170,000 | $105,000 |
| Disposition of the partnership interest | | |
| FMV of the property received | | |
| 50% of the land | $ 25,000 | $ 25,000 |
| 50% of the building | 100,000 | 100,000 |
| POD | 125,000 | 125,000 |
| ACB | (170,000) | (105,000) |
| Capital gain (loss) | $ (45,000) | $ 20,000 |

2. If the subsection 98(3) election is made:

a. For the partnership:

There are no tax consequences. The partnership is deemed to have disposed of the property at its cost amount, being:

| | |
|---|---|
| Land | $ 20,000 |
| Building | $100,000 |

b. For Alex and Janine:

There is no income on the disposition by the partnership, and consequently there is no adjustment to the ACB of either Alex's or Janine's interest.

| | Alex | Janine |
|---|---|---|
| Disposition of the partnership interest | | |
| POD = the greater of the following amounts: | | |
| • ACB of the partnership interest | $ 105,000 | $ 40,000 |
| • share of the cost amount of the property received (50% of $120,000) | $ 60,000 | $ 60,000 |
| POD | $ 105,000 | $ 60,000 |
| ACB | (105,000) | (40,000) |
| Capital gain | $ — | $ 20,000 |
| Cost of property received | | |
| Land | $ 25,000* | $ 10,000 |
| Building | | |
| Capital cost | $ 70,000 | $ 70,000 |
| CCA deemed to have been claimed | (20,000) | (20,000) |
| UCC | $ 50,000 | $ 50,000 |

* Because the ACB of Alex's interest exceeded his share of the cost amount of the property received from the partnership ($105,000 – $60,000 = $45,000), an adjustment to the cost of the land may be made under paragraphs 98(3)(b) and (c). However, this adjustment may not be used to increase the cost of the property to an amount greater than Alex's share of the FMV of the property, being $25,000.

Form T2060 must be filed no later than June 15, 2009, the date by which the income tax and benefit returns of Janine and Alex must be filed.

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The provisions of subsection 98(3) are rarely used and are employed mainly where there is a merger of two partnerships (read IT-471R). There is no specific provision in the ITA that allows the tax-free merger of two (or more) partnerships. However, a merger may be accomplished using a combination of subsections 98(3) and 97(2). One of the two partnerships, which desires to merge, ceases to exist and uses the provisions of subsection 98(3) so that the partnership is dissolved with minimum tax consequences. Following the dissolution of the partnership, each member of the dissolved partnership holds an undivided interest in all the property belonging to the dissolved partnership. All the partners then use the provisions of subsection 97(2) to transfer their undivided interest in the property of the former partnership tax-free to the other partnership. On completion of this series of transactions, only one partnership remains and the merger is accomplished.

## Business continued by one partner

Under subsection 98(5), a partner of a partnership that ceases to exist may receive partnership property without tax consequences for the partnership and, in addition, defer all or part of the capital gain that would normally arise on the disposition of his partnership interest.

A number of conditions must be met:

- The partnership must be a Canadian partnership.
- The partnership must have ceased to exist.
- One of the partners must have commenced to carry on the business of the former partnership within three months after the partnership ceased to exist. This partner must use the assets of the partnership in the course of the business.
- This rule applies automatically and no election is required to be filed.

Where all of the conditions are met, the following tax consequences arise on the rollover:

- The POD of the partnership interest for the partner continuing the business are deemed to be the greater of
  - (i) The total of the ACB of his partnership interest immediately before the dissolution, and the cost to him of any interest in the partnership acquired by him; where a partner acquires all the interests held by the other partners, he is deemed not to have acquired the partnership property.
  - (ii) The total of the cost amount to the partnership, immediately before the dissolution, of each property received and the amount of any other proceeds of disposition of his partnership interest.
- Where the deemed POD are equal to the ACB, there will be no capital gain or loss arising from the transaction. If the deemed POD are greater than the total of the cost amount of the property received from the partnership and the other amounts received, subsection 98(5) provides for adjustments to the cost amount of capital property (other than depreciable property) received, up to the amount of its FMV.
- The ITA does not take into account the liabilities of the partnership. They should be repaid or assumed by the partner continuing the business. If they are assumed, a contribution of capital increasing the ACB of his interest is deemed to have occurred.
- If the cost amount of the depreciable property for the partner is less than the partnership's original capital cost, the partner is deemed to have a capital cost equal to the partnership's original capital cost and to have claimed the excess of the capital cost over the cost amount of the property to the partner as CCA.
- The partnership is deemed to have disposed of each property allocated to the partner continuing the business for proceeds equal to the cost amount of the property, immediately before the dissolution.
- The other partners are deemed to have disposed of their interest for proceeds equal to the FMV of the property received as consideration for their interest. The partnership property distributed to these partners will be deemed to have been disposed of by the partnership at its FMV.

Example 7-16 shows the tax consequences when the activities of a partnership are continued by one of the partners.

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EXAMPLE 7-16

France Bigras and Lucy Kwan have been carrying on a business in partnership since 1991. Lucy, who is 60 years of age, wishes to retire. France wishes to continue the business. On February 1, France purchases Lucy's interest in the partnership for $30,000 and continues to carry on the business as a sole proprietorship.

The partnership's year-end is January 31. At that date, the partnership's balance sheet is as follows:

| **Assets** | | **Liabilities** | |
|---|---|---|---|
| Cash | $ 10,000 | Accounts payable | $ 75,000 |
| Inventory | 5,000 | | |
| Land (cost) | 10,000 | **Partners' capital** | |
| Building | 75,000 | | |
| | | France | 15,000 |
| | | Lucy | 10,000 |
| | $100,000 | | $100,000 |

Additional information:

- The cost of the building is $85,000 and its UCC is $75,000.
- The FMV of the assets is

| | |
|---|---|
| Inventory | $ 10,000 |
| Land | $ 20,000 |
| Building | $100,000 |

- The ACB of the partnership interests for France and Lucy is equal to their capital.
- France assumes the partnership's liabilities before the acquisition of Lucy's interest. The amount assumed will then be added to the capital account as a contribution of capital which increases the ACB of France's interest.

***Tax consequences***

1. For Lucy:

| | |
|---|---|
| POD | $ 30,000 |
| ACB | (10,000) |
| Capital gain | $ 20,000 |
| Taxable capital gain (1/2) | $ 10,000 |

2. For France:

Subsection 98(5) applies

- Disposition of the partnership interest
  POD = the greater of the following amounts:

| | | | |
|---|---|---|---|
| i) ACB of the interest ($15,000 + $75,000) | $ 90,000 | | |
| Cost of the interest acquired from Lucy | 30,000 | $120,000 | |
| ii) Cost of the property received from the partnership | | $100,000 | $120,000 |
| ACB of the interest after the acquisition of Lucy's interest | | | (120,000) |
| Capital gain | | | $ — |

- Cost of the property received by France

| | | |
|---|---|---|
| Cash | | $ 10,000 |
| Inventory | | $ 5,000 |
| Land* | | $ 20,000 |
| Building — Capital cost | $ 85,000 | |
| CCA deemed to have been claimed | (10,000) | |
| UCC | | $ 75,000 |

* Because the ACB of France's interest exceeds the cost amount of the property received from the partnership, she may increase the cost of non-depreciable capital property received, being the land, up to its FMV. See paragraphs 98(5)(b) and (c). The unutilized portion of the excess of the ACB over the cost amount of the property is lost.

# READING 7-7

## Limited partnership

LEVEL 2

Where more than one investor is required for a business project, sometimes a legal mechanism known as a limited partnership is used. In a limited partnership, the funds are assembled without the limited partners having any greater liability than if they had invested in the shares of a corporation.

Limited partnerships are primarily used in the real estate field to avoid liability for Part I.3 tax and the capital tax that would be imposed in some provinces on a corporation with real estate holdings.

The liability of limited partners in a limited partnership is different from that of partners in any other type of partnership. Their liability is limited to the amount of their capital contribution, meaning that they are not jointly and severally liable for the partnership's acts and are not required to compensate for losses incurred by the limited partnership. The general partner alone is liable and has control over the business. However, the partnership agreement may sometimes provide for an additional contribution if the partnership has a cash deficit. This limited liability has led the tax authorities to provide strict legislation on the deductibility of losses that may be claimed by a limited partner.

### Limited partner

Under subsection 96(2.4), a partner is considered to be a limited partner if, while a partner or within three years after the time of his partnership

- by operation of any law which governs the partnership arrangement, the partner's liability toward the partnership is limited;
- the partner or a related person is entitled to receive an amount or obtain a benefit that would reduce any loss from his partnership interest;
- one of the reasons for the existence of the partner (such as a shell corporation) may reasonably be considered to be to limit the liability of any other person and not to permit another person to carry on the business in the most effective manner;

or

- there is an agreement for the disposition of an interest in the partnership and it may reasonably be considered that one of the main reasons for the agreement is to circumvent this definition of limited partner.

### Deductibility of losses

Under subsection 96(2.1), a limited partner may deduct losses and investment tax credits (ITCs) of a limited partnership that are allocated to him only up to his "at-risk amount" at the end of the partnership's taxation year ending in his own taxation year. The portion of a business loss arising from a limited partnership that cannot be deducted in the current year is called a **limited partnership loss**. Under paragraph 111(1)(e), this loss may be carried forward and deducted in the subsequent taxation year, provided the limited partner's at-risk amount has increased. More specifically, subsection 96(2.1) states that a limited partnership loss is equal to the excess of

- the loss allocated to a limited partner for a fiscal period ending in the year (other than from a farming business or income from property)

over

- the excess of the "at-risk amount" at the end of the fiscal period over the total of
  - the ITC allocated to the limited partner in the year
  - the loss allocated to the limited partner from a farming business

- the limited partner's share of resource-related expenses, such as foreign exploration and development expenses, Canadian exploration expense, Canadian development expense and Canadian oil and gas property expense incurred by the partnership in the fiscal period

In computing the ACB of a limited partner's interest, an undeducted loss does not reduce the ACB which, on disposition, would convert a non-capital loss into a lower capital gain or higher capital loss.

## "At-risk amount" for the first purchaser

Under subsection 96(2.2), the "at-risk amount" of the first purchaser equals the total of

- the ACB of the interest at that time
- his share of the income of the partnership for that taxation year

less

- any amount owing to the partnership or to a person or partnership related to the partnership by the limited partner or a related person
- any amount or benefit which the limited partner or a related person is entitled to receive for the purpose of reducing any loss relating to his interest

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EXAMPLE 7-17

In October 2008, Dave McDonald subscribed for a $20,000 interest in Geyser, a limited partnership. He made a cash payment of $5,000 and signed a demand note for $15,000 payable to Geyser on January 15, 2009. For the fiscal period ending December 31, 2008, the limited partnership allocated an operating loss of $18,000 to Dave in proportion to his interest, of which $3,000 represents resource expenses.

***Tax consequences***

1. Computation of the at-risk amount [96(2.2)]:

| | | |
|---|---|---|
| ACB of the interest | | $ 20,000 |
| Less: Amount due to Geyser | | (15,000) |
| At-risk amount | | $ 5,000 |

2. Computation of the non-deductible loss [96(2.1)]:

| | | |
|---|---|---|
| Excess of the allocated loss computed under 96(1)(g) over | | $ 18,000 |
| At-risk amount | $ 5,000 | |
| Less: Resource expenses | (3,000) | (2,000) |
| Non-deductible limited partnership loss | | $ 16,000 |

3. Computation of the deductible loss:

| | |
|---|---|
| Allocated loss | $ 18,000 |
| Non-deductible loss | (16,000) |
| Deductible loss | $ 2,000 |
| Deductible resource expenses | $ 3,000 |
| Loss carryforward against partnership income or deductible loss in the event of an increase in the at-risk amount ($15,000 – $2,000) | $ 13,000 |

In 2008, Dave is entitled to a total deduction of $5,000 in computing income, equal to his at-risk amount.

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## Negative ACB

It was previously explained that the provisions of paragraph 40(3)(a) do not apply when the ACB of a partnership interest becomes negative. In other words, when a partnership interest is negative, there is no capital gain.

However, when the ACB of an interest in a limited partnership becomes negative, subsection 40(3.1) provides that a member is deemed to realize a capital gain at the end of the fiscal period of the limited partnership. The provisions of subsection 40(3.1) apply only if the member is a limited partner of the partnership or has been a specified member of the partnership since becoming a member. Certain exceptions are provided for when the interest was held by the member on February 22, 1994.

As defined in subsection 248(1), a specified member is a member who

a. is a limited member of the partnership

or

b. is not actively engaged on a regular, continuous, and substantial basis in the activities of the partnership other than financing, and is not carrying on a business similar to the one carried on by the partnership, otherwise than as a member of a partnership.

## Anti-avoidance rules

Subsections 96(2.6) and (2.7) contain anti-avoidance rules regarding the at-risk amount. The purpose of these provisions is to deny an increase in the at-risk amount through an artificial reduction in the limited partner's debt or an artificial increase in the capital contribution to the partnership.

Subsection 96(2.6) states that, where an amount is repaid and it subsequently appears that the repayment was made as part of a series of loans and repayments, the amount owing shall be deemed not to have been repaid. The at-risk amount will therefore be reduced by the amount deemed not to have been repaid.

Similarly, subsection 96(2.7) provides that, where a taxpayer makes a capital contribution and the partnership or a related person makes a loan to a limited partner or repays the contribution of capital and it is part of a series of transactions designed to increase the at-risk amount, the capital contribution shall be deemed not to have been made.

# Transfer of property by a partnership to a corporation

## LEVEL 1

A rollover of property from a partnership to a corporation under subsection 85(2) by means of an election made by a corporation and all the members of a partnership is subject to the same rules as transfers under subsection 85(1). (See Form T2058.)

Subsection 85(3) contains special rules for the rollover of assets from a partnership to its partners following a transfer to a Canadian corporation, provided certain conditions are met. This rollover rule is therefore an exception to the general rule under which property must be transferred from a partnership to its partners at FMV so that a capital gain may result on the deemed disposition by the partners of their partnership interest.

The conditions of this rollover are

- The partnership, which does not have to be a Canadian partnership as defined in section 102, makes an election under subsection 85(2) jointly with the taxable Canadian corporation in respect of a disposition of property.
- Within 60 days after the disposition, the affairs of the partnership are wound up, with all the partnership's assets, including cash, being allocated to the members in settlement of their interest in the partnership. (See IT-378R.)
- Immediately before the winding-up of the partnership, there was no partnership property other than money or property received from the Canadian corporation on the rollover.

The rules applicable to the subsection 85(3) rollover are

- The partnership is deemed to have disposed of its property for proceeds equal to its cost amount; therefore no income is realized by the partnership on the transfer of the property.
- Each partner is deemed to have disposed of his partnership interest for proceeds equal to the amount of money received plus the deemed cost for tax purposes of the shares and other property of the Canadian corporation transferred. The deemed POD are then compared to the ACB of the partner's interest to determine if a gain has been realized.
- The deemed cost for each partner of the property of the corporation received as consideration is determined as follows:

  a. property (other than shares or a right to receive shares):
  the FMV at the time of the winding-up

  b. preferred shares of the corporation:
  the lesser of:
  (i) the FMV of the preferred shares
  (ii) the ACB of the partner's interest in the partnership immediately before the winding-up
  less:
  the FMV of the property other than shares received on the winding-up

  The deemed cost is allocated among the various classes of preferred shares in proportion to the FMV of the shares of a class over the FMV of all the preferred shares received.

c. common shares of a corporation:
the ACB of the partner's interest in the partnership immediately before the winding-up
less:
(i) the FMV of the property received other than shares
and
(ii) the deemed cost of the preferred shares received

In summary, in determining the deemed cost for a partner of property received from the partnership on its winding-up, the ACB of the interest is allocated first to property other than shares of the corporation and then to the preferred and common shares, respectively.

Consequently, where money and other property received by a partner do not exceed the ACB of his interest, there is a complete rollover on winding-up.

Example 7-18 shows how subsection 85(2) applies.

EXAMPLE 7-18

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Marcos Medeiros and Ann Candy are equal partners in Sonar Partnership. Marcos' ACB of the partnership interest is $125,000 and Ann's is $25,000. Sonar Partnership transfers all its property to Sonar Ltd. under the provisions of subsection 85(2). The property sold and the consideration received are as follows:

| | FMV | Agreed amount* | Consideration | |
|---|---|---|---|---|
| Property A: | $100,000 | $ 75,000 | Note | $ 75,000 |
| | | | Preferred shares | 25,000 |
| Property B: | 100,000 | 50,000 | Cash | 25,000 |
| | | | Preferred shares | 25,000 |
| | | | Common shares | 50,000 |
| Property C: | 100,000 | 1 | Common shares | 100,000 |
| | $300,000 | $125,001 | | $ 300,000 |

* In this example, the cost amounts and agreed amounts are the same.

The FMV of the assets held by the partnership immediately before the winding-up is as follows:

| | |
|---|---|
| Cash and note | $ 100,000 |
| Preferred shares | 50,000 |
| Common shares | 150,000 |
| | $ 300,000 |

Sonar Partnership is wound up within 60 days after the disposition of the property to Sonar Ltd. Consequently, the partnership property is deemed to be transferred to the two partners in equal portions at its cost amount of $125,001. Therefore, the partnership does not realize any gain on the transfer.

***Tax consequences***

In determining whether there is a gain on the deemed disposition of the partnership interest by each partner, the deemed costs of the property received must be determined:

1. For Marcos:

Non-share consideration (NSC)

| | | |
|---|---|---|
| Cash (FMV) | | $ 12,500 |
| Debt (FMV) | | 37,500 |
| | | 50,000 |

Preferred shares

| | | |
|---|---|---|
| The lesser of: | | |
| • FMV of the preferred shares | $ 25,000 | |
| • ACB of the interest – NSC ($125,000 – $50,000) | $ 75,000 | 25,000 |

Common shares

| | |
|---|---|
| ACB of the interest – (NSC + Cost of preferred shares) | |
| $125,000 – ($50,000 + $25,000) | 50,000 |
| Total | $125,000 |

2. For Ann:

Non-share consideration (NSC)

| | | |
|---|---|---|
| Cash (FMV) | | $ 12,500 |
| Debt (FMV) | | 37,500 |
| | | 50,000 |

Preferred shares

| | | |
|---|---|---|
| The lesser of: | | |
| • FMV of the preferred shares | $ 25,000 | |
| • ACB of the interest – NSC ($25,000 – $50,000) | $ — | — |

Common shares

| | |
|---|---|
| ACB of the interest – (NSC + Cost of preferred shares) | |
| $25,000 – ($50,000 + 0) | — |
| Total | $ 50,000 |

The capital gain for each partner will be

| | Marcos | Ann |
|---|---|---|
| POD | $ 125,000 | $ 50,000 |
| Less: ACB | (125,000) | (25,000) |
| Capital gain | $ — | $ 25,000 |

When the assets of a partnership are rolled over to a corporation under subsection 85(2), CRA allows the shares to be issued directly on behalf of the partners rather than on behalf of the partnership, even though the latter is the transferor. This avoids having to transfer securities following the winding-up of the partnership.

# READING 7-9

## Information return

### LEVEL 1

REG 229(1) stipulates that an information return must be filed for each fiscal period of the partnership. Each member of the partnership is responsible for filing a return, but under REG 229(2) one member may do so on behalf of all the others.

The return must include the following information:

- the income or loss of the partnership for the period
- the name, address and social insurance number of each partner
- each partner's share of the income or loss of the partnership for the period
- each partner's share, for the period, of each deduction, credit or other amount that is relevant in computing taxable income or income tax payable
- other required information in respect of research and development expenditures

However, certain types of partnerships may be exempted from filing a return by the Minister. Exempted to date are

- partnerships with fewer than six members during any fiscal period, provided that none of the members is itself a partnership
- limited partnerships whose activities during the fiscal period consisted solely of making investments in flow-through shares

REG 229(5) provides for time limits for the filing of information returns:

- if all members are corporations: five months after the end of the partnership's fiscal period
- if all members are individuals: March 31 of the year following the year in which the partnership's fiscal period ended
- if the members consist of some combination of individuals, corporations, trusts or other partnerships: on the earliest of the following dates:

  i) five months after the end of the partnership's fiscal period

  or

  ii) March 31 of the year following the year in which the partnership's fiscal period ended

If the partnership ceases to exist [REG 229(6)], the return must be filed by the earliest of the following dates:

- 90 days after the date on which activities ceased

or

- the date that would otherwise constitute the statutory filing date if the partnership had not ceased its activities

The information return consists of various forms or schedules, to be filed depending on the activities of the partnership; for information on this subject, read IC 89-5R.

- T5013 Summary — Partnership Information Return
- T5013 Sch. 1 — Statement of Partnership Income
- T5013 Sch. 8 — Partnership Capital Cost Allowance Schedule
- T5013 Sch. 50 — Reconciliation of Partner's Capital Account
- T5013 Sch. 52 — Summary Information for Tax Shelters that are Partnerships or for Partnerships that Allocated Renounced Resource Expenses to their Members

- T5013 Sch. 10 — Calculation of Deduction for Cumulative Eligible Capital of a Partnership
- T661 — Claim for Scientific Research and Experimental Development Expenditures Carried on in Canada (if applicable)