In Print

The Taxation of Partnerships in Canada

by Elizabeth J. Johnson and Genevieve C. Lille

Wilson & Partners LLP

(a law firm affiliated with PricewaterhouseCoopers LLP)

Published in *Bulletin for International Taxation*

This article reviews the Canadian regime for taxation of partnerships and their members. While the *Income Tax Act* generally does not impose entity-level tax on a partnership, it requires that the income or loss of the partnership initially be computed as if the partnership were a separate person, and that the income or loss then be allocated to the partners. The fiscally transparent nature of partnerships under Canadian law has historically made them attractive vehicles for tax-motivated investments and useful in the international context, when tax benefits may flow from the different characterization of partnerships in two jurisdictions. This article examines basic principles governing partnerships created under Canadian law, classification for legal and tax purposes, basic tax regime and the provisions of the *Income Tax Act* that facilitate partnership reorganizations, as well as various rules aimed at limiting tax benefits associated with partnerships, such as the at-risk rules and the tax shelter investment rules applicable to limited partnerships, and the recent SIFT rules designed to limit tax benefits derived from income trusts. Finally, the article reviews international aspects of partnership taxation, including recent changes to the Canada-U.S. Treaty.

Elizabeth Johnson elizabeth.j.johnson@ca.pwc.com

Genevieve Lille genevieve.c.lille@ca.pwc.com

Originally published by:

Bulletin for International Taxation (August/September 2009), CTF: pp. 381-394

PRICEWATERHOUSECOOPERS

*Elizabeth J. Johnson and Geneviève C. Lille**

The Taxation of Partnerships in Canada

This article examines the taxation of partnerships in Canada. After introductory remarks giving an overview of the Canadian approach to partnership taxation, the types of partnerships recognized by Canadian law and the Income Tax Act of Canada, and the status of limited partners under the Act, the article considers specific aspects of partnership taxation. The article discusses, among other things, what is recognized as a partnership under the Act, the basic regime, special rules applicable to limited partnerships, international aspects of partnership taxation, and the anti-avoidance rules and case law relating to partnerships.

1. Introduction

1.1. Canadian Approach to Partnership Taxation – Overview

Under Canadian principles, a partnership is the relation that subsists between persons carrying on a business in common with a view to profit. As discussed below, the requirements for a business which is carried on in common with a view to profit are considered the three key requirements for a partnership to exist under Canadian law.

A partnership is generally treated as a conduit or flow-through vehicle for Canadian income tax purposes. Its income or losses are allocated to its members and, subject to limited exceptions, the Income Tax Act of Canada[1] ("the Act") does not subject the partnership to an entity-level tax.

The flow-through nature of a partnership historically made partnerships a popular vehicle for tax-motivated investments that relied on the allocation of losses to investors to generate a favourable investment return. The "at-risk" rules and the "tax shelter" investment rules were introduced in the mid-1980s to curtail this use of partnerships.

More recently, it had been advantageous to use partnerships in publicly-traded investment structures expected to generate income rather than losses.[2] Such structuring avoids the entity-level tax that applies to profits of corporations. Measures known as the "SIFT" rules (see 6.) were recently adopted to reduce the tax benefits of these structures.

Partnerships are often used in cross-border structures, where the beneficial tax results flow from "hybrid" classification; that is, the partnership is treated as a flow-through vehicle for purposes of the tax rules in one jurisdiction and as an entity that is taxed separately from its members in another jurisdiction. Recent amendments to the Canada–United States tax treaty[3] deny the treaty rate of withholding tax in certain Canada–US hybrid entity structures.

Considerable scope remains to use partnerships in tax structuring, but the recently implemented changes and various anti-avoidance rules must be considered.

1.2. Types of partnerships recognized by Canadian law and the Income Tax Act

Canadian commercial law generally recognizes two forms of partnerships: the general partnership and the limited partnership. The partnership statutes of most Canadian provinces now recognize a third variant, the limited liability partnership.

In a general partnership, subject to the partnership agreement, all partners may take part in the management of the partnership business. Every partner is an agent of the firm and of the other partners for purposes of the partnership business, and every partner is liable jointly with the other partners for all debts and obligations of the firm incurred while the person is a partner.[4] There is no requirement that a general partnership register or take formal steps for the partnership relationship to exist, although the partners will typically want to formalize the arrangement through a written partnership agreement.

A limited partnership is sometimes referred to as a "creature of statute" because a partnership cannot be a limited partnership without the partnership being formed under a statute, such as the Ontario Limited Partnerships Act.[5] A limited partnership must have at least one general partner and at least one limited partner, but provided

Elizabeth J. Johnson, LLB, LLM, is a partner in Wilson & Partners LLP, Toronto, a law firm affiliated with PricewaterhouseCoopers LLP. She is the co-author of *Understanding the Taxation of Partnerships* (CCH Canadian Limited, 5th ed., 2006).

Geneviève C. Lille, LLB, is an associate in Wilson & Partners LLP, Toronto, a law firm affiliated with PricewaterhouseCoopers LLP.

1. R.S.C. 1985, Chap. 1 (5th Supp.), as amended. Unless otherwise indicated, all statutory references are to the Income Tax Act.
2. These structures typically use a combination of partnerships and trusts to eliminate the entity-level tax. Trusts are also affected by the "SIFT" rules; see 6.
3. Income and capital tax treaty between the United States of America and Canada signed on 26 September 1980, as amended by the protocols signed on 14 June 1983, 28 March 1984, 17 March 1995, 29 July 1997 and 21 September 2007.
4. See, for example, Secs. 6 and 10 of the Ontario Partnerships Act, R.S.O. 1990, Chap. P.5, as amended.
5. Limited Partnerships Act, R.S.O. 1990, Chap. L.16, as amended. This Act provides that a limited partnership is formed when a declaration is filed with the Registrar.

that the limited partner does not take part in the control of the partnership business, the limited partner is afforded limited liability.

The limited liability partnership (LLP) is a relatively new creature of statute that should not be confused with the limited partnership.[6] Under the laws of most Canadian provinces, LLPs may be formed to carry on the business of certain professions, subject to the relevant regulatory regime. A partner in a typical LLP has a form of limited liability under which he or she is generally not liable for the negligent acts or omissions committed by another partner (or an employee under another partner's supervision and control).

1.3. Limited partner status under the Income Tax Act

The treatment of a particular partner under the Act can vary depending on whether the partner is considered to be a "limited partner" as defined in the Act. Among other things, if a partner is a limited partner, specific at-risk rules apply to restrict the partner's ability to deduct partnership losses.

For purposes of the relevant provisions of the Act, the term "limited partner", defined in Sec. 96(2.4), includes, but is not limited to, a partner who has the status of limited partner under limited partnership legislation. A taxpayer is a limited partner in a partnership at a particular time if, at that time or within three years after that time, any of the following conditions is met:
(a) by operation of any law governing the partnership arrangement, the partner's liability as a partner of the partnership is limited;
(b) the partner (or any person not dealing at arm's length) is entitled, absolutely or contingently, to receive certain types of benefits prescribed by the at-risk rules;
(c) one of the reasons for the existence of the partner is to limit the liability of any person with respect to the partnership and not to permit any person having an interest in the member to carry on that person's business in the most effective manner; or
(d) there is an agreement or other arrangement for the disposition of an interest in the partnership, and one of the main reasons for the agreement or arrangement is to circumvent the definition of "limited partner".

2. What is Recognized as a Partnership for Purposes of the Income Tax Act?

2.1. Basic principles

Although the term "domestic partnership" is sometimes used in a tax planning context to describe a partnership constituted under the laws of a Canadian province and the term "foreign partnership" is used to refer to a partnership governed by foreign law, these terms have little relevance for Canadian income tax purposes. The Act does not define the term "partnership", but does define, in Sec. 102, the term "Canadian partnership", which is important for certain purposes. As discussed later, many reorganization provisions apply only to a "Canadian partnership". Further, certain payments made to a non-Canadian partnership may be subject to Part XIII withholding tax. There is no requirement that a Canadian partnership carry on all or any part of its business in Canada or that it be organized under Canadian law. The definition simply requires that all the partners be resident in Canada at the time the definition is applied.[7]

A taxpayer must demonstrate that the requirements for a partnership to exist under Canadian principles have been met if the taxpayer claims that a partnership exists for purposes of the Act.[8] Under Canadian law, many of the common law principles governing the creation and existence of partnerships have been codified by provincial partnership statutes.

Generally, the laws of all the common law provinces of Canada define a partnership as the relation that subsists between or among persons carrying on a business in common with a view to profit. Thus, both as a matter of common law and the statutory overlay, there are three "essential ingredients" of a partnership under Canadian principles: (i) a business (ii) that is carried on in common by two or more persons (iii) with a view to profit.

A tax motivation for forming a partnership or acquiring an interest in a partnership does not derogate from a finding of partnership so long as the three essential ingredients are present.

Virtually any commercial undertaking can be a "business" as that term is used in provincial partnership legislation. A partnership does not need to be formed to operate a continuing business; it can be formed for a single transaction, and the business may simply be the passive receipt of rent.[9]

2.2. Classification of foreign business or investment vehicles as partnerships

The recognition of a business or investment vehicle as a partnership under the laws of a foreign jurisdiction or its classification as a partnership under foreign taxation laws does not mean that it will be considered a partnership for purposes of the Act. According to the Canada Revenue Agency (CRA), the status of a foreign entity for Canadian tax purposes involves a "two-step approach", namely, determining the characteristics of the foreign business association under foreign commercial law, and comparing these characteristics with those of recognized categories of business association under Canadian commercial law in order to classify the foreign business association under one of those categories.[10]

6. But a member of an LLP may be a limited partner as defined in the Act.
7. In addition, the SIFT rules (discussed in 6.) use the defined term "Canadian resident partnership".
8. *Continental Bank Leasing Corporation v. The Queen*, 98 DTC 6505; *Spire Freezers Ltd. v. The Queen*, 2001 DTC 5158; *Backman v. The Queen*, 2001 DTC 5149 (all decisions of the Supreme Court of Canada).
9. *Backman*, id.
10. The CRA's current approach is explained in Income Tax Technical News No. 38, 22 September 2008.

One of the aspects of a partnership as it is understood under Canadian law is that a partnership is a relationship and not an entity, even if certain acts may be taken in the name of the partnership. In contrast, under some foreign partnership laws, the partnership is considered to have separate legal entity status. This has resulted in uncertainty as to the status of some partnerships formed under foreign legislation for purposes of the Act.

The CRA now accepts that separate legal entity status under the foreign law is not determinative of the status of an arrangement for Canadian tax purposes. The CRA has confirmed that it considers partnerships formed under the Delaware Revised Uniform Partnership Act (DRUPA) and the Delaware Revised Uniform Limited Partnerships Act (DRULPA), Australian limited partnerships and French "*sociétés en nom collectif*" to be partnerships.

An election by a corporation to be taxed as a partnership for tax purposes in a foreign jurisdiction is not relevant to the determination of its status as a partnership for purposes of the Act, although the election may be relevant to determining its eligibility for treaty benefits.

2.3. Partnerships distinguished from other forms of joint ventures

This article does not discuss the taxation of other forms of unincorporated business vehicles. While the Act provides specific rules governing the manner in which a partnership is taxed, there are no rules that apply specifically to joint ventures. The terms "syndicate" and "association" are also sometimes used to describe a form of joint venture that is not a partnership. Generally, the CRA's position (supported by case law) is that a joint venture may be a partnership in some instances, but a joint venture may also exist as a form of business association distinct from a partnership. A joint venture is more likely to be found not to constitute a partnership if it is formed for a limited term or for a single undertaking and if the parties agree to share gross revenue and expenses rather than to share profits.

3. Overview of Basic Regime

The main rules governing the taxation of partnerships are contained in Subdivision J of Division B of Part I of the Act (Sec. 96 through 103).

3.1. Partnership not a person

The Act imposes tax on "persons".[11] A partnership is not a person, nor is it deemed to be one for purposes of the Act generally.

3.2. Computation of partnership income

The basic regime requires a computation of income (or loss) at the partnership level and an allocation of the income (or loss) to the members of the partnership. The primary basis for the allocation is the partnership agreement, subject to any express limitations imposed by the Act, and the application of specific or general anti-avoidance rules.

Although a partnership is not a person for purposes of the Act generally, the Act requires a computation of the income (or loss) of the partnership from each source,[12] and from sources in a particular place, as if the partnership were a separate person in order to determine each partner's income (or loss) from those sources. A computation is also required of taxable capital gains and allowable capital losses from the disposition of partnership property.

Income (or loss) from various sources computed at the partnership level is allocated to the partners. Each partner reports his or her share of the partnership income (or loss) in his or her return for the partner's taxation year in which the fiscal period of the partnership ends, and pays tax accordingly. If a partnership loss that is allocated to a partner in a particular taxation year cannot be deducted by the partner in the current year, the loss may be carried forward or back in accordance with the normal rules that apply to losses, unless restrictions apply (as in the case of limited partnership losses).

Special rules apply to certain types of partnership expenditures that give rise to incentive tax deductions, such as resource expenditures, scientific research and experimental development (SR&ED) expenditures and expenditures qualifying for investment tax credits.[13] The application of these rules to partnerships, and in particular to limited partnerships, is complex and beyond the scope of this article.

3.3. Partnership's fiscal period

Generally, a partnership any of whose members is an individual must use the calendar year as its fiscal period. A partnership that has only corporations (other than professional corporations) as members may still choose any fiscal period (not longer than 53 weeks).

3.4. Adjusted cost base (ACB) of a partnership interest

The ACB of a partner's partnership interest is relevant in determining the capital gain or capital loss on the disposition of the partnership interest.[14] The taxpayer's ACB of an interest in a partnership of which the taxpayer is, or is deemed to be, a limited partner is also relevant in com-

11. Sec. 2(1) requires the income tax to be paid on the taxable income of every person resident in Canada, and Sec. 2(2) imposes tax on a person who, while not resident, was employed in Canada, carried on a business in Canada, or disposed of taxable Canadian property during the year.
12. The Act requires a calculation of income from each source, which may be a "property" source or a "business" source, and also a computation of income from such sources on a territorial basis.
13. For instance, Canadian exploration expenses (CEE), Canadian development expenses (CDE), Canadian oil and gas property expenses (COGPE) and foreign resource expenses (FRE) incurred by a partnership are not deducted at the partnership level, but are allocated to each partner who is a member of the partnership at the end of the partnership's fiscal period.
14. Although a partnership interest may be held as inventory, this article discusses only the principles that apply to determine the ACB of a partnership interest that is held as capital property, i.e. where any gain on the disposition would be taxable as a capital gain (only one half of which is taxable).

puting the partner's "at-risk amount" in respect of the partnership under the at-risk rules discussed below.

If the partner contributes cash or transfers assets to the partnership in return for a partnership interest, the cost of that interest will normally be the cash contributed or, in the case of a transfer of other property, the net fair market value (FMV) of the transferred property.[15] The cost to a taxpayer of a partnership interest acquired from another person will normally be the purchase price paid for that interest.

The *cost* of the partnership interest, otherwise determined, is subject to various positive and negative adjustments provided in Sec. 53 to arrive at the ACB. The overall purpose of the adjustments is to preserve the "conduit" nature of the partnership for tax purposes and eliminate the double-counting of income and loss items that would otherwise result.

The following are some of the key additions to the ACB of a partnership interest at a particular time:

(1) The partner's share of the partnership income from all sources for each completed fiscal period of the partnership that ended before the particular time, including the full amount of the partner's share of any capital gains of the partnership.[16]

(2) Any contribution of capital made to the partnership before the particular time otherwise than by loan.

(3) The partner's share of certain items that, if received directly by the partner, would be non-taxable, such as life insurance proceeds and "capital dividends".[17]

Some of the key deductions in computing the ACB at a particular time are:

(a) The partner's share of the partnership losses from all sources for each completed fiscal period of the partnership that ended before the particular time, including the full amount of any capital losses.

(b) Any amount received before the particular time as a distribution of partnership profits or partnership capital.

(c) The partner's share of any "limited partnership loss" to the extent such loss was deducted in computing the partner's income.

(d) In certain cases, the unpaid principal amount of any indebtedness of the partner for which recourse is limited and which is related to acquiring the partnership interest.

(e) The partner's share of the partnership's resource expenditures.[18]

(f) The partner's share of charitable and political donations made by the partnership.

(g) Any amount deducted by the partner as investment tax credits allocated to the partner by the partnership.

These lists are not exhaustive; they include the most common adjustments.

3.5. Disposition of a partnership interest

Partnership interests may be disposed of in various ways. The partner may transfer the partnership interest to another party who then becomes a member of the partnership. On withdrawal from a partnership, a disposition of the partnership interest occurs. If a partnership dissolves, each partner is considered to dispose of his or her partnership interest. There are other instances (e.g. death) in which a partnership interest is deemed disposed of.

On the disposition of the partnership interest, the partner normally realizes a capital gain (or capital loss) equal to the amount by which the proceeds of disposition received or deemed to be received for the partnership interest exceed (or are less than) the ACB of the partnership interest.

If the partnership interest is disposed of during the partnership's fiscal year, consideration must be given to whether the transferor will be allocated income (or loss) for that year, or whether the income (or loss) will only be allocated to persons who are members of the partnership at the end of the year. Whether or not income (or loss) will be allocated to persons who transfer a partnership interest at some point during a fiscal period depends, for the most part, on the terms of the partnership agreement.

Drawings during the fiscal period of a partnership reduce the partner's ACB of the partnership interest when received, but the ACB adjustments for the income and loss of a fiscal period occur only once the fiscal period is completed. This can give rise to anomalous results when a partner disposes of a partnership interest during the year. Some pending technical amendments would permit the current year's income (and losses) allocated to a partner who ceases to be a partner during a fiscal year to be reflected in the partner's ACB immediately before the time of disposition.[19]

Although the Act treats a partnership interest as distinct from its underlying assets, some of the provinces do not make such a distinction for purposes of certain taxes, such as the retail sales tax or land transfer tax. In those provinces, a transfer of the partnership interest will have the same provincial retail sales tax or land transfer tax

15. That is, the FMV of the transferred property less any consideration, such as cash, a promissory note or assumption of liabilities, that is also received on the transfer. If property is transferred to the partnership on a tax-deferred basis under Sec. 97(2), the cost of the partnership interest will depend on the elected amount.

16. The adjustment to the ACB for the income and losses of a particular fiscal period occurs only *after* the fiscal period is completed. This leads to anomalous results in some cases.

17. Non-taxable capital dividends may be paid by private corporations out of a notional account that includes certain non-taxable receipts.

18. These amounts are not deducted at the partnership level, but are allocated to the partners to be deducted by them personally.

19. Proposed Sec. 96(1.01) and related proposed amendments to Sec. 99(1), dealing with dissolution of a partnership. The CRA has been somewhat accommodating in permitting adjustments notwithstanding the lack of specific legislative authority, although less so recently.

consequences as a sale of a pro rata interest in the partnership assets.

3.6. Disposition of a partnership interest to a tax-exempt entity

The normal rule is that only one half of a capital gain is taxable. However, the taxable portion of the capital gain realized on a disposition of a partnership interest may be increased to the full amount (100%) if the partnership interest is disposed of to a tax-exempt person (Sec. 100(1)). Tax-exempt persons include pension funds and funding vehicles. The rule is aimed at the avoidance of depreciation recapture and other income inclusions through the sale of a partnership interest, rather than the sale of the underlying property, where the purchaser is a tax-exempt person.

3.7. Negative ACB of a partnership interest – deemed capital gain

Sec. 40(3) of the Act provides that if a taxpayer's ACB of a capital asset "goes negative" at any time (i.e. the negative adjustments exceed the positive adjustments), the amount of the negative ACB is deemed to be a capital gain from a disposition at that time of the asset. Partnership interests are generally excluded from the rule. However, Secs. 40(3.1) and (3.11) require the negative ACB of a member who is a "limited partner" or a "specified member" of the partnership to be treated as a capital gain from the disposition of the partnership interest.

For this purpose, the definition of "limited partner" is substantially the same as discussed earlier. The term "specified member" generally refers to a member who is not actively engaged on a regular, continuous and substantial basis in the activities of the partnership.

If a partner is required to recognize a gain because the ACB of the partnership interest became negative, the ACB is restored to a *nil* balance.

4. Some Interpretive Issues

4.1. When is a partnership a taxpayer or a person?

The view of a partnership as a relationship is referred to as the "aggregate theory" of partnership and is contrasted with the "entity theory", which views the partnership as a separate legal entity. The partnership rules in the Act reflect both theories. A partnership is not treated as a separate taxable entity, consistent with the aggregate theory. Nevertheless, the Act requires a computation of the income (or loss) of the partnership as if the partnership were a separate person. Not surprisingly, many interpretive issues arise when dealing with a provision in the Act that is not explicit as to its application to partnerships.

The CRA's approach follows three principles:
– a partnership is not a person, unless the Act specifically deems it to be so;
– a partnership is considered to be a person when the matter involves computing income at the partnership level; and
– in cases where a partnership is not viewed as a person, a reference to "person" in a particular section may be read as a reference to the partners of the partnership.

Many of the computational rules are, in fact, drafted to explicitly apply to both persons and partnerships.

4.2. Partnership assets and liabilities

4.2.1. Whose assets or liabilities?

The question of the nature of a partner's interest in the partnership assets and the partner's obligation for the partnership debts is relevant to the interpretation of some provisions of the Act and of tax treaties.

Under the aggregate theory of partnership, the partners are considered to have some kind of proprietary interest in the partnership assets. Nevertheless, while the partnership exists, no partner may treat partnership assets or the proceeds of a sale of partnership assets as his or her own.

Whether or not the debt of a partnership constitutes debt issued by the partners is an important matter in interpreting numerous provisions of the Act, including the thin capitalization rules in Sec. 18(4).

4.2.2. Thin capitalization rules not applicable to partnerships

The thin capitalization rules in Sec. 18(4) of the Act (and related provisions) limit the amount of deductible interest expense of corporations resident in Canada on the debt owed to significant shareholders. Generally, for interest to be fully deductible, the debt must be maintained within a 2:1 debt-to-equity ratio.

Despite the fact that the CRA sometimes applies the rules in the Act as though the partners of a partnership have issued partnership debt, the CRA historically has not attempted to assert that the thin capitalization rules should apply to limit the interest expense that may be claimed by a partnership having corporations as members, other than through recharacterizing the tax results under the general anti-avoidance rule (GAAR) in Sec. 245.

The CRA's analysis is that, since the thin capitalization rules are rules for computing income, they should be applied at the partnership level. Since the rules only apply in computing the income of a corporation resident in Canada and since interest expense is a deduction claimed at the partnership level, the CRA accepts that technically the rules do not apply to a partnership, even if only corporations resident in Canada are members. If there is a bona fide partnership and the partners are jointly and severally liable for the partnership debt, the partnership is considered the debtor and Sec. 18(4) will not apply. If, however, the partnership structure is adopted to avoid the thin capitalization rules, the CRA will attempt to apply the GAAR to limit the deductible interest expense to what it would be if the debt were the debt of the corporate partners.

In *Wildenburg Holdings Ltd. v. Ontario*,[20] which involved Ontario's corporate tax, it was held that, in the circumstances, debt on property held "in partnership" was the debt of the partners and not of the partnership. The mortgagee had expressly agreed that each partner's liability was limited to 50% of the principal and interest secured under the mortgage. The CRA has stated[21] that it will apply *Wildenburg* in a similar factual situation, but otherwise its position remains as before. From time to time, the Department of Finance has stated that it would consider extending the thin capitalization rules to partnerships, but no legislative action has yet been taken.

4.2.3. Loans by corporations to shareholders

Sec. 15(2) is designed to prevent the distribution of funds of a Canadian corporation to or for the benefit of its shareholders free of tax through the use of loans or other forms of indebtedness, rather than the payment of a dividend. Under the rule, any amount owed by a shareholder (other than a Canadian corporation) to a Canadian corporation is included in income once the loan has been outstanding for a certain period. Loans to Canadian resident corporations are excluded because dividends between two Canadian corporations generally flow tax free (due to the deduction in Sec. 112(1) for such dividends).

Sec. 15(2) is an example of a provision where the legislature went to some lengths to ensure that not only *persons* incurring debt to a Canadian corporation, but also *partnerships*, are subject to the rule. Further, if the creditor is not the corporation itself but a partnership of which the corporation is a member, the debtor is similarly subject to the rule.

Despite the detailed drafting, interpretive uncertainties remain. The circumstances in which a "person" is "connected" to a shareholder are set out in the legislation, but no express mention is made of a "partnership" in the relevant rule (Sec. 15(2.1)).

The CRA's view is that a partnership can be a person "connected" for this purpose. According to the CRA, Sec. 15(2) is a computational rule, and therefore it is not necessary that the rule mention both *persons* and *partnerships*. The Tax Court of Canada disagreed with this interpretation in *Gillette Canada Inc. v. The Queen*,[22] but the precedential value of this case is uncertain.[23]

4.3. Dividends received by a partnership

A corporation resident in Canada includes in income a dividend received from another Canadian corporation and, subject to certain anti-avoidance rules, obtains a deduction in computing taxable income. The result is a tax-free flow of dividends between Canadian corporations. Individuals include a "grossed-up" dividend in income, but qualify for a dividend tax credit. The purpose of these rules is to achieve a degree of integration of the corporate level and shareholder level taxes.

The CRA considers dividends on shares of Canadian corporations held through a partnership to be received by the partners for purposes of the dividend deduction granted to corporations and the gross-up and credit rules applicable to individuals. Any expenses relating to earning dividend income are expenses of the partnership which may be allocated to the members.

A detailed discussion of the "foreign affiliate" rules in the Act is beyond the scope of this article, but the general principle is that the dividends received by Canadian corporations on shares of foreign affiliates qualify for beneficial tax treatment, depending on the source of the dividends (i.e. whether out of active business income or not). Foreign affiliate status depends on whether an ownership test is met. The beneficial treatment consists of a deduction in computing taxable income for all or part of the dividends, similar to the deduction available to Canadian corporations for dividends on shares of other Canadian corporations.

Express provisions (in Sec. 93.1) attribute ownership of the shares of a foreign corporation held by a partnership to the partners, as well as dividends received by the partnership on the shares, for purposes of the foreign affiliate rules. Some problematic technical issues remain in this area, however.

5. Special Rules Applicable to Limited Partnerships

As noted earlier, partnerships have commonly been used as vehicles for tax-motivated investments, or tax shelters, because of the ability to flow losses or deductions through to their members. Various rules exist to curtail the benefits of such arrangements.

5.1. The at-risk rules

Sec. 96 of the Act provides for an allocation of any losses of the partnership from various sources to its members. However, Sec. 96(2.1) provides that a taxpayer who is, at any time in a taxation year, a limited partner of a partnership may deduct a loss of the partnership only to the extent of the taxpayer's "at-risk amount" as of the end of the partnership's fiscal period ending in that year.

In general terms, the partner's at-risk amount is calculated as the partner's ACB of the partnership interest, increased by the partner's share of the current year's income from the partnership and reduced by all amounts owing by the partner to the partnership and any amount or benefit to which the partner is entitled, where the amount or benefit is intended to protect the partner against the loss of the amount invested.

20. 98 DTC 6462 (Ontario Court of Justice), upheld 2001 DTC 5145 (Ontario Court of Appeal).
21. Income Tax Technical News 16, 8 March 1999.
22. 2001 DTC 895.
23. The taxpayer's position was upheld, but on other grounds, by the Federal Court of Appeal (2003 DTC 5078). The Court expressly declined to express a view on the interpretation of Sec. 15(2.1).

A loss that cannot be deducted in a particular taxation year because of these limitations is deemed to be the taxpayer's "limited partnership loss" in respect of the partnership for the year. Such losses are eligible for an indefinite carry-forward, but are generally deductible in future years only to the extent that the taxpayer's at-risk amount in respect of the partnership increases – for instance, because the partnership has generated income or the taxpayer has made additional capital contributions to the partnership.

A partner's at-risk amount is not computed solely by reference to that partner's ACB if the partner is a second or subsequent holder of a partnership interest. In this case, Sec. 96(2.3) deems the subsequent holder's cost of the interest, only for purposes of the at-risk rules, to be the lesser of its actual cost to the holder and its ACB to the taxpayer from whom it was acquired. The effect of this provision is to ensure that the at-risk amount is increased only to the extent that the amount of capital actually contributed to the partnership has increased.

5.2. Tax shelters and tax shelter investments

Another set of rules may potentially apply to limit the tax benefits that might otherwise flow to a taxpayer in respect of an investment in a partnership. The "tax shelter" regime in the Act has two aspects. The first is a requirement, in Sec. 237.1, for tax shelters to be registered with the CRA. The purpose of this regime is to enable the CRA to detect trends in tax shelter promotions as well as to easily identify promoters and investors.

The other aspect of the regime involves limiting deductions and credits in cases outside the scope of the normal at-risk rules, but where the taxpayer is otherwise protected from realizing an economic loss. These rules, known as the "tax shelter investment" rules, are found in Sec. 143.2 of the Act.

An interest in a partnership is not necessarily a tax shelter, but because partnerships are commonly used as vehicles for investment arrangements that fall within the tax shelter rules, it is important to consider these rules.

A "tax shelter" is property in respect of which certain statements or representations are made or proposed to be made as to the available deductions or other tax benefits being received within a specified period as a result of investing in the property. A promoter of a tax shelter must apply to the Minister of National Revenue in the prescribed form for an identification number. Penalties apply for failing to obtain a number before selling an interest in the tax shelter. No amount may be claimed or deducted by a person in respect of an interest in a tax shelter unless the person provides the identification number of the tax shelter.

The key rule denying deductions in respect of tax shelter investments is in Sec. 143.2(6). It provides that the amount of any expenditure that is, or is the cost or capital cost of, a taxpayer's "tax shelter investment" and the amount of any expenditure of a taxpayer an interest in which is a tax shelter investment may be reduced by certain amounts. For this purpose, Sec. 143.2(1) expressly provides that the term "taxpayer" includes a partnership.

A tax shelter investment includes any property that otherwise meets the definition of "tax shelter" in Sec. 237.1 of the Act, but the definition goes beyond the investments that require registration. For example, if a taxpayer that is itself a tax shelter acquires an interest in a partnership that would not itself be a tax shelter, the partnership interest is a tax shelter investment.

The reductions required by Sec. 143.2(6) fall into two main categories. The first category is chiefly concerned with limited recourse debt relating to the tax shelter investment and includes what are referred to as "limited recourse amounts"; the second category is in respect of certain benefits referred to as "at-risk adjustments". In very general terms, if an interest in a partnership is a tax shelter investment, the expenditures of either the partnership or the partner may be reduced by limited recourse amounts or at-risk adjustments at either level. The term "limited recourse amount" is not restricted to limited recourse debt, but may include other indebtedness. Extreme care must be taken to consider these rules and their potential application at both the partner and partnership levels.

6. SIFT Partnerships

On 31 October 2006, the Department of Finance announced the introduction of a corporate-level tax on certain flow-through entities.[24] The tax generally applies to publicly-traded trusts and partnerships referred to as "specified investment flow-through" ("SIFT") entities. The stated intent of the SIFT rules is to level the playing field between, on the one hand, Canadian tax-exempt and non-resident investors in flow-through entities and, on the other, Canadian investors subject to tax under the Act. The SIFT rules became effective on 31 October 2006 (the date of their announcement), but SIFT partnerships that existed on 31 October 2006 and conform to published "normal growth guidelines"[25] will only become taxable under the new rules starting in 2011.

The main purpose of the rules is to eliminate the tax advantages associated with a form of investment vehicle, the "income trust", that had become increasingly prevalent in Canada. An income trust is an ownership vehicle for certain assets or businesses. The publicly-traded vehicle is established to qualify as a "mutual fund trust". In most structures, the publicly-traded mutual fund trust in turn invests in units and debt of a lower-tier trust, and

24. The rules became law in 2007. Some technical difficulties were addressed in legislation passed in early 2009.
25. The effective date of 2011 will not be accelerated for a particular SIFT entity if the increase in its equity capital does not exceed the greater of CAD 50 million and a safe-harbour amount. The safe-harbour amount is based on the value of the SIFT's equity on 31 October 2006. See Department of Finance News Release 2006-082 and the Explanatory Notes released on 25 February 2009 relating to later technical amendments.

the lower-tier trust often holds an interest in a partnership with an operating business. The result of the multiple tiers of flow-through vehicles is that the income of the operating business can flow through to the public investors without any corporate-level tax.[26] Many public Canadian corporations had converted, and others were in the process of converting, to income trust structures when the new measures were announced.

The new tax, imposed under Part IX.1 of the Act, applies to a partnership that is a "SIFT partnership", that is:
– the partnership is a "Canadian resident partnership" as defined in Sec. 248(1);
– the "investments" in the partnership are listed or traded on a stock exchange or other public market; and
– the partnership owns one or more "non-portfolio properties".

The term "Canadian resident partnership" includes not only a Canadian partnership, but also any partnership that was formed under the laws of a Canadian province or that would, if it were a corporation, be resident in Canada (including a partnership having its central management and control in Canada). Thus, a partnership that is not a Canadian partnership for other purposes of the Act may be a SIFT partnership simply by virtue of being formed under Canadian law or by virtue of having its central management and control in Canada.

A partnership is a SIFT entity only if it holds non-portfolio property. "Non-portfolio property" generally includes the shares of a corporation or trust resident in Canada, or an interest in a Canadian resident partnership (defined as "subject entities"), if the partnership holds securities in the subject entity that either (i) comprise at least 10% of the FMV of all the equity value of the subject entity or (ii) together with securities held by affiliated parties, exceed 50% of the FMV of all the equity value of the partnership. A non-resident corporation, a non-resident trust or a partnership that is not a Canadian resident partnership may also be a "subject entity" if its principal source of income is one or a combination of sources in Canada. "Non-portfolio property" also includes property that the particular partnership, or a person or partnership with whom the particular partnership does not deal at arm's length, uses at that time in the course of carrying on a business in Canada.

The term "investment" for purposes of the SIFT rules is defined by reference to a "security" of the partnership. The defined term "security" is broader than the standard commercial meaning of the term would suggest, as is the definition of "public market".

An entity-level tax is imposed under Part IX.1 of the Act on the non-portfolio earnings of a SIFT partnership. The term "non-portfolio earnings" refers to the income of the partnership from businesses carried on in Canada, income from non-portfolio properties and taxable capital gains from the disposition of non-portfolio properties. Tax is imposed on such earnings at a rate equal to the combined federal and provincial general corporate tax rates.

The non-portfolio earnings of a SIFT partnership (less the Part IX.1 tax paid on such earnings) are treated as a dividend received by the partnership from a taxable Canadian corporation. The dividend is allocated to the partners, where it retains its character and is subject to the general rules governing the taxation of dividends.

7. International Aspects of Partnership Taxation

7.1. Partnerships with non-resident members

7.1.1. Carrying on business in Canada and dispositions of taxable Canadian property

If a partnership with non-resident members earns income from carrying on business in Canada or realizes a gain on the disposition of taxable Canadian property, the non-resident members are subject to tax on their share of any such income or gains, subject to treaty relief. Each partner is considered to carry on any business that is carried on by the partnership, regardless of whether the partner actively participates in the business of the partnership or is a general or limited partner.

Generally, the following items are included in computing a non-resident partner's taxable income earned in Canada in respect of the partnership:
– the partner's share of any income of the partnership from the businesses carried on in Canada;
– the partner's share of any taxable capital gains from dispositions of taxable Canadian property (other than "treaty-protected property"), net of the non-resident partner's share of any allowable capital losses from dispositions of taxable Canadian property (other than "treaty-protected property"); and
– the partner's share of any proceeds of disposition of the partnership's Canadian resource properties.

The non-resident partner's share of any loss of the partnership from any business carried on in Canada (other than a "treaty-protected business") generally reduces the partner's taxable income earned in Canada.

"Treaty-protected property" means property the income or gain from which is exempt from tax under Part I because of a tax treaty with another country. A "treaty-protected business" is a business in respect of which any income of the taxpayer is exempt because of a tax treaty with another country. Both definitions are in Sec. 248(1).

Canada's tax treaties typically provide that Canada may only tax a non-resident entitled to treaty benefits on business profits that are attributable to a permanent establishment of the non-resident in Canada. If a partnership with a non-resident member who is resident in a treaty country has a permanent establishment in

26. In older structures, the operating business might still have been in a corporation, but the corporation would have been leveraged with as much debt as possible to optimize the flow-through of income.

Canada, that permanent establishment is considered a permanent establishment of the non-resident member.

A non-resident corporation that is a member of a partnership that carries on business in Canada is subject to the "branch tax" levied under Part XIV. The branch tax approximates the dividend withholding tax that would be paid if the non-resident corporation carried on the branch activities through a Canadian subsidiary and the subsidiary's after-tax profits were repatriated to the parent corporation in the form of dividends, to the extent not reinvested in Canada. The branch tax is levied at the basic rate of 25%. If a tax treaty reduces the rate of withholding tax on dividends paid by a subsidiary to its foreign parent, the rate of the branch tax is reduced correspondingly. The branch tax may be partly or entirely relieved by the provisions of a tax treaty.

If a non-resident carries on business in Canada or disposes of taxable Canadian property in the year, but is not subject to tax because of treaty protection, the non-resident must still generally file a Canadian tax return claiming the treaty benefit. Further, if a partnership with non-resident members disposes of taxable Canadian property, the procedures in Sec. 116 (which require a certificate to be obtained and/or a filing to be made if a non-resident disposes of taxable Canadian property) must be complied with.

The definition of "taxable Canadian property" includes shares of Canadian corporations (other than, in general, publicly-listed shares, provided a specific ownership threshold is not exceeded) and property used in a business carried on in Canada. An interest in a partnership constitutes taxable Canadian property if, at any time in the 60-month period preceding the disposition of the interest, the FMV of any of its properties that were taxable Canadian property represented more than 50% of the total value of all of its property.

7.1.2. Withholding tax under Part XIII

If a resident of Canada pays or credits an amount to a partnership other than a Canadian partnership, the partnership is deemed to be a non-resident person for purposes of Part XIII of the Act (Sec. 212(13.1)(*b*)). Withholding tax may apply, for example, to a payment of interest or dividends by a Canadian resident to a partnership with a non-resident member or a payment of rent or royalties for the use of property in Canada to such a partnership.

The CRA's position has been that, for purposes of interpreting Canada's tax treaties, if the relevant amount is paid to a partnership, the partners will be considered to be the "beneficial owners" of the income and, as such, can claim treaty benefits on their share of the amounts paid to the partnership.

Further, where it is clear that some members of a non-Canadian partnership are entitled to treaty benefits, the CRA considers that the payer may withhold at the lower treaty rate based on the proportion of the relevant payment that can be considered to be beneficially owned by those members. If the identity of the members might be in question, tax should initially be withheld at 25% and a refund should be applied for on behalf of those members who can establish entitlement to the reduced treaty rate.

Some treaties provide a reduced rate of withholding tax on dividends paid on shares of a corporation if an ownership threshold is met. For example, under the Canada–US treaty, if the beneficial owner of the dividends received on shares of a Canadian corporation is a company resident in the US that owns at least 10% of the voting stock of the Canadian corporation, the withholding tax rate on dividends is reduced from 15% to 5%.

The CRA's view is that, while a partnership is a conduit and its partners can be viewed as the beneficial owners of items of income paid to the partnership (with the result that the beneficial owners can benefit from reduced treaty rates on their share of such items), this does not mean that the partners have proportionate ownership of the partnership property. Therefore, unless the relevant treaty expressly attributes ownership of the partnership property to the partners for purposes of the rules governing the dividend withholding rate, the lower "direct" dividend rate may not be available for dividends on shares held through a partnership. The fifth protocol to the Canada–US treaty recently amended the treaty to permit a US corporation that receives dividends on shares of a Canadian corporation held through a partnership (that is considered fiscally transparent for US purposes) to qualify for the 5% rate if the US corporation's proportionate ownership interest in the partnership is at or above the 10% threshold.

7.1.3. Withholding on fees for services rendered in Canada

Fees, commissions and any other amounts paid to a non-resident of Canada for services rendered in Canada are subject to a 15% withholding tax (Regulation 105(1)). This withholding is required regardless of any exemption available to the non-resident under a tax treaty. A waiver of withholding may be available in such circumstances if obtained before the services are rendered, but in many cases, it is not practical to obtain a waiver on a timely basis.

The CRA's view on services performed in Canada by partnerships having non-resident members is that withholding is required based on the non-resident members' percentage participation in the partnership.[27]

One of the impractical aspects of this interpretation is that a payer often does not have the information required to determine whether there are non-resident members and, if so, their percentage participation. Even if all of the members of a partnership are non-residents, the withholding obligation may result in hardship, par-

27. Information Circular 75-6R2, *Required withholding from amounts paid to non-residents performing services in Canada*, 23 February 2005.

ticularly for large foreign partnerships that perform some services in Canada, but whose members are exempt from Canadian tax on that income under a treaty. Once the tax has been withheld, the only way a member can recover it is by filing a Canadian income tax return. Foreign partnerships in this situation often simply decide to forego the tax recovery.

7.2. Canadian members of partnerships with foreign income

For purposes of the foreign tax credit rules in Sec. 126 of the Act, all members of a partnership include in their income from the businesses carried on by them in a foreign country and from other sources in that country their share of the partnership income from those sources in that country. Each member's business income tax and non-business income tax in respect of a foreign country is considered to include the member's share thereof paid by the partnership.[28] Interest costs and other expenses incurred outside the partnership may reduce the "net foreign income" of a partner for purposes of determining entitlement to a foreign tax credit.

7.3. Hybrid entities and recent changes to the Canada–US treaty

In international tax planning, the terms "hybrid" and "reverse hybrid" are often used to describe entities that are treated as fiscally transparent in one jurisdiction and as non-fiscally transparent in another.[29] An example of a hybrid entity is a Nova Scotia unlimited liability company (NSULC) or an Alberta unlimited liability company (AULC) which, for Canadian purposes, is considered a corporation but which may be treated as a "disregarded" entity for US tax purposes. Similarly, a US limited liability company (LLC) is viewed as a corporation for Canadian tax purposes but, by default, is considered a disregarded entity or partnership for US tax purposes. A reverse hybrid includes a partnership that is respected as such for Canadian tax purposes, but is treated as a corporation for US tax purposes.

A detailed discussion of the many ways in which such entities have been used in international tax structuring is beyond the scope of this article, but the basic premise is that tax benefits may flow from the different ways in which such an entity is characterized in two jurisdictions.

For example, the hybrid characterization of an NSULC may permit a US corporation to participate in a partnership in Canada on a tax-efficient basis. The US corporation might invest in a Canadian partnership through a wholly-owned NSULC to maintain the partnership's status as a "Canadian partnership". This would allow dividends, interest and other passive investment income to be paid to the partnership without withholding tax applying to such payments. It would also allow the partnership and its partners to take advantage of a number of tax-deferred reorganization provisions in the Act and to dispose of taxable Canadian property without being required to obtain a Sec. 116 clearance certificate.

Before the effective repeal of the "non-resident owned investment corporation" or "NRO" rules in Sec. 133 of the Act as of 2003, NROs were often used by US multinational corporations to finance their Canadian operating subsidiaries. An NRO was a Canadian corporation that was taxed under a special regime allowing it to pay a refundable tax of 25% on interest received by it, which tax was refundable on the payment of a dividend equal to the interest received. The NRO held the interest-bearing debt of a Canadian operating company owned by the US parent. The NRO's tax refund was obtained by paying stock dividends (subject to Canadian withholding tax) which were ignored for US tax purposes. The net effect was that the Canadian subsidiary obtained an interest deduction and that Canadian withholding tax was paid (at 10% rather than the 5% dividend rate), but no current US tax was payable.

Until recently, a common use of a reverse hybrid was in a financing structure typically referred to as a "synthetic NRO" because it was devised to produce the same tax benefits as were previously available under the NRO rules. Although variations on the structure exist, a US parent corporation with a Canadian operating subsidiary might form a limited partnership (with another subsidiary as the other partner) under the laws of a province of Canada. The Canadian limited partnership would elect to be treated as a corporation for US tax purposes. The Canadian limited partnership would make an interest-bearing loan to the Canadian operating subsidiary (replacing the loan that would have been held by the NRO in the former structure). The Canadian operating company would pay interest to the partnership and would withhold tax at the treaty rate; however, because the partnership was considered a corporation for US purposes, the US parent company could defer including the interest in income.

Changes to the Canada–US treaty made by the fifth protocol affect much of this planning. In particular, changes to Art. IV of the treaty, effective in 2010, subject the dividends and interest paid by a Canadian hybrid entity, such as an NSULC, to a US resident to the full non-treaty rate of withholding tax. New Para. 7 of Art. IV contains two anti-hybrid rules. Both rules deem a payment not to be made to a treaty resident. Looked at from a Canadian perspective, the first rule, in Art. IV(7)(a), deems the income not to be paid to or derived by a US resident if the person is considered under Canadian law to have derived the amount through an entity that is not a US resident and, because the entity is not treated as fiscally transparent under US law, the treatment of the amount is not the same as if the amount had been derived directly by a US resident.

28. Interpretation Bulletin IT-270R3, *Foreign Tax Credit*, 25 November 2004.
29. The term "hybrid" is also often used to describe financial instruments that are classified differently in two jurisdictions, i.e. as debt in one jurisdiction and as equity in another.

This provision applies to income derived by a US resident through a Canadian partnership that is viewed, for US purposes, as a corporation and not a partnership, such as in the synthetic NRO structure.

The second rule, in Art. IV(7)(b), applies to income derived by a US resident that is viewed by Canada as received from an entity resident in Canada, where the entity is treated as fiscally transparent under US law and, by reason of that fiscally transparent treatment, the treatment of the amount received is not the same as it would be if the entity were treated as not fiscally transparent.

This provision applies to income derived by a US resident from an entity, such as an NSULC, that is considered resident in Canada but is disregarded for US purposes, e.g. where the NSULC is interposed between a US corporation and a partnership that carries on business in Canada.

These changes take effect on 1 January 2010. Many existing operating and financing structures are adversely affected by these rules. There has been some indication from Canadian Department of Finance officials that the rules may be unintentionally broad, but any solution must be by way of a further protocol to the treaty.

8. Partnership Reorganizations

8.1. Basic rules – FMV disposition

In general, a transfer of property to a partnership by a partner is considered to result in a disposition of property at FMV and an acquisition of the property by the partnership at FMV (Sec. 97(1)). Thus, the partner recognizes any accrued gain (including recaptured depreciation) and, subject to certain stop-loss rules, any accrued loss.

Similarly, if a partnership transfers property to a partner, whether on a dissolution of the partnership or in satisfaction of the partner's interest in the partnership on a withdrawal from the partnership, the partnership is considered to have disposed of the property at FMV (Sec. 99(2)).

Fortunately, the Act allows some reorganizations involving partnerships to take place on a non-recognition or "rollover" basis. "Rollovers" are often referred to as "tax-free" transactions, but the term "tax-deferred" is actually more appropriate because the gain is not always entirely eliminated; also, the gain that is not recognized in the transaction will normally be recognized at a later time, when the property is disposed of in a non-rollover transaction.

Most of the partnership rollovers are available only if the partnership in question is a Canadian partnership. The key rollovers available are discussed briefly below.

8.2. Transfer of property to Canadian partnership – Sec. 97(2)

Certain eligible property may be transferred by a taxpayer to a Canadian corporation on a tax-deferred basis, provided shares are received in the transaction and an election is made under Sec. 85(1) of the Act. The basic rule provides that gain is recognized only to the extent that the non-share consideration received (often referred to as "boot"), such as cash, a promissory note or assumption of liabilities, exceeds the transferor's cost of the assets for purposes of the Act. The amount designated in the election form as the proceeds of disposition of the transferred property (the "elected amount") may be anywhere between the cost of the asset and its FMV, subject to a minimum elected amount equal to the boot allocated to the asset. The elected amount then becomes the cost of the property to the corporation.

The rollover for property transferred to a Canadian partnership under Sec. 97(2) is modelled on the Sec. 85(1) rollover and has many of the same requirements. The transferor must be a member of the partnership immediately after the transfer. An election must be filed and, if the transferor receives boot (i.e. consideration other than a partnership interest or an increased partnership interest) in excess of the transferor's cost, a gain must be recognized. The minimum elected amount is the amount of boot allocated to the transferred asset, but subject to this requirement, the elected amount may be anywhere between the tax cost and the FMV. The partnership's cost of the transferred property is the elected amount.

Although the types of property that can be transferred to a partnership on a rollover basis are slightly broader than in a rollover under Sec. 85(1), the Sec. 97(2) rollover provision is inherently narrower because of the requirement that the partnership be a Canadian partnership immediately after the transfer, that is, all the partners must be Canadian residents.

The following property is eligible for transfer to a Canadian partnership under Sec. 97(2):
- most capital property;
- Canadian resource property;
- foreign resource property;
- eligible capital property; and
- inventory of the transferor.

A key difference is that the definition of "eligible property" for purposes of a rollover to a corporation under Sec. 85(1) excludes inventory that is real property. There is no such restriction in Sec. 97(2). Therefore, real estate inventory can be transferred to a Canadian partnership on a rollover basis using an election under Sec. 97(2). This difference may be useful in planning that relates to real estate joint ventures and reorganizations involving real estate inventory.

8.3. Partnership dissolutions

8.3.1. Overview

Normally, when a partnership is dissolved because the partners have agreed to terminate the partnership business, the liabilities of the partnership will be provided for (i.e. either repaid or assumed by the partners), and the assets of the partnership will be sold or distributed to the partners.

Several provisions may permit a partnership to be dissolved on a tax-deferred rollover basis:

(a) Sec. 98(3) provides an elective rollover where a Canadian partnership is dissolved and each member of the partnership immediately before the dissolution receives an undivided interest in each asset of the partnership;

(b) Sec. 98(5) provides an automatic rollover to a former partner of a Canadian partnership who continues the partnership business as a sole proprietor;

(c) Sec. 98(6) provides an automatic rollover when a Canadian partnership is dissolved and its assets are transferred to another Canadian partnership all of whose members were partners of the dissolved partnership; and

(d) Sec. 85(3) provides a means whereby a partnership may be dissolved on a tax-deferred basis if its assets are transferred to a Canadian corporation in a transaction in respect of which an election is made under Sec. 85(2) and the partnership is dissolved within 60 days after that transfer.

8.3.2. Sec. 98(3) dissolution

For Sec. 98(3) to be available, the partnership assets must be distributed on the dissolution on the basis that each former partner's proportionate co-ownership interest in any one asset following the dissolution is the same as his or her proportionate interest in every other asset. This requirement (which the CRA interprets strictly) makes the provision somewhat limited in its practical utility, at least in arm's length situations. If the partners of a partnership wish to dissolve the partnership, they do not usually want to continue to be co-owners of the assets. In this case, the dissolution of the partnership in reliance on Sec. 98(3), in and of itself, has not accomplished very much. If, however, the assets that are distributed on the winding-up can then be "partitioned" such that each former partner's undivided interest is exchanged for an ownership interest in the assets that is separate property, it should be possible for such partitioning to occur without adverse tax consequences.

If Sec. 98(3) applies, it does not necessarily assure a wholly tax-deferred transaction. Whether there is a gain depends on the ACB of the partnership interest relative to the cost of the assets distributed to the partner. The partnership is deemed to have disposed of the assets at their cost so that gain should not arise at the partnership level. However, a partner is required to recognize gain to the extent that the cost of the partnership assets distributed exceeds the partner's ACB of the partnership interest immediately before the dissolution. There could be a discrepancy between the partner's share of the "inside" basis in the partnership assets and the partner's "outside" basis, i.e. the ACB of the partnership interest, if, for example, the partner acquired the partnership interest from another partner.

8.3.3. Sec. 98(5) – continuation of partnership business by one partner as sole proprietor

Sec. 98(5) applies where, at any particular time, a Canadian partnership has ceased to exist, and:
- within three months after that time, one of the former members of the partnership (the "proprietor") carries on alone the business that was the business of the partnership; and
- the proprietor continues to use, in the course of that business, any assets that were, immediately before the particular time, partnership assets and that were received by the proprietor as the proceeds of disposition of the proprietor's interest in the partnership.

If the conditions for the application of Sec. 98(5) are met, it simply applies; no election is required.

The rules in Sec. 98(5), as applicable to the proprietor, are similar to the rules in Sec. 98(3). As under Sec. 98(3), gain arises if the cost of the assets distributed to the proprietor exceeds the ACB of the partnership interest (which includes the cost of any partnership interest acquired from any other partner).

8.3.4. Reconstitution of a Canadian partnership that dissolves – Sec. 98(6)

Pursuant to Sec. 98(6), when a Canadian partnership ceases to exist at any time and, at or before that time, all the assets of that partnership are transferred to a new Canadian partnership that consists solely of members of the old partnership, the new partnership is deemed to be a continuation of the old partnership, and a member's interest in the new partnership is deemed to be a continuation of his or her old partnership interest. This provision also applies automatically if the qualifying conditions are met.

This rule was likely primarily intended to deal with the situation where, as a matter of partnership law, the death of a partner or the withdrawal of one or more partners from a partnership could result in a termination of the partnership and the constitution of a new partnership by the remaining partners.

8.3.5. Incorporation of a partnership – Secs. 85(2) and (3)

Sec. 85(2) is a complementary provision to the rollover provision in Sec. 85(1), which applies where eligible property is transferred by a taxpayer to a taxable Canadian corporation for consideration that includes shares of the transferee corporation.

With some relatively minor modifications, Sec. 85(2) adopts the rules in Sec. 85(1), but applies where a *partnership* transfers partnership assets to a taxable Canadian corporation for consideration that includes shares of the transferee corporation, and the corporation and all the members of the partnership jointly elect that the provisions of Sec. 85(2) will apply.

While Sec. 85(2) stands on its own as a rollover provision that allows the transfer of property by a partnership to a taxable Canadian corporation, it is often used in conjunction with Sec. 85(3) because Secs. 85(2) and (3), taken together, provide a means whereby an undertaking carried on in partnership form can be "converted" into corporate form without adverse tax consequences for the partners.

Sec. 85(3) applies where a partnership disposes of assets to a corporation in a transaction to which Sec. 85(2) applies, and the partnership affairs are wound up within 60 days of the disposition. Immediately before the partnership is wound up, there can be no partnership assets other than money or assets that were received from the corporation as consideration for the disposition.

Sec. 85(2) is an elective provision, but Sec. 85(3) is not. If the conditions for applying Sec. 85(3) are met, its application is automatic.

A notable difference between a reorganization carried out using these provisions and the other forms of reorganizations discussed above is that it is not a requirement that the partnership be a Canadian partnership for Sec. 85(3) to apply. Further, it is not necessary under Sec. 85(3) for each former partner to receive an undivided interest in each partnership asset, as under Sec. 98(3). Therefore, if, on the dissolution of a partnership, the former partners are content to continue their business relationship in corporate form, this rollover may be quite flexible.

The fact that Secs. 85(2) and (3) apply to a transfer of assets to a corporation followed by a winding-up of the partnership does not guarantee a completely tax-free or tax-deferred transaction. This depends on whether it is possible to elect under Sec. 85(2) an amount that does not result in a gain on the initial transfer of assets to the corporation. It also depends on the partner's ACB of the partnership interest and the amount of non-share consideration received from the transferee corporation.

8.3.6. Mergers of partnerships

There is no provision specifically allowing a tax-free merger or combination of partnerships to take place. In order to achieve that result, it is necessary to undertake a series of steps that allows the parties to rely on a combination of two separate partnership rollover provisions. The two partnership rollover provisions that are relevant are Secs. 97(2) and 98(3). As discussed above, both of these provisions require that the partnership be a Canadian partnership.

If the partners of two partnerships wish to merge their operations, the typical options are one of the following:

(a) Each partnership would be wound up on the basis that Sec. 98(3) could be relied on. That is, each of the partners of the two partnerships would receive an undivided interest in each partnership asset which, when expressed as a percentage of all undivided interests in that asset, was equal to the undivided percentage interest received in each other partnership asset. All the partners of each of the dissolved partnerships would transfer their undivided interests in the assets received on the winding-up of their former partnerships to a new partnership for consideration under the Sec. 97(2) rollover provisions.

(b) Alternatively, each partnership could transfer all its assets to a new partnership for a partnership interest in the new partnership, electing under Sec. 97(2) in respect of that transfer. Once this transaction has been completed, the only asset of each of the pre-existing partnerships would be the partnership interest in the new partnership. Each of the existing partnerships would then dissolve and distribute its assets to its partners, electing under Sec. 98(3). Each former partner would receive an undivided co-ownership interest in the new partnership. Provided that this partnership interest can then be "partitioned", it should be possible for such partitioning to occur without adverse tax consequences. A variation on this approach would require only one of the partnerships to transfer its assets.

9. Anti-Avoidance Rules and Tax Avoidance Jurisprudence relating to Partnerships

The GAAR is a general anti-avoidance rule that permits the tax consequences of "avoidance transactions" to be recharacterized so as to deny the tax benefits that would otherwise result, provided the Minister of National Revenue has demonstrated that the provisions of the Act have been abused. The specific anti-avoidance rules relevant to partnerships include Secs. 103(1) and (1.1).

Sec. 103(1) provides that, where the members of a partnership (whether arm's length or non-arm's length) have agreed to share the income or loss of the partnership from any source, or any other amount relevant to computing the income of any member, in a certain manner and where the principal reason for such agreement may reasonably be considered to be the reduction of tax, the share of each member in the income or loss from various sources will instead be such amount as is reasonable having regard to all the circumstances.

Sec. 103(1.1) permits the Minister to reallocate income, losses or any other amounts among non-arm's length partners who have agreed to a sharing arrangement that is not reasonable in the circumstances having regard to the capital invested in, or work performed for, the partnership by its partners or any other relevant factors.

The courts have not been hesitant to apply specific anti-avoidance rules or the GAAR to tax structures involving partnerships, particularly where the partnership is used in an attempt to transfer losses to unrelated parties or to shift partnership income to a partner who, due to being in a loss position, is indifferent to the receipt of income. Examples in the case law include:

– *XCO Investments Ltd. v. The Queen*.[30] A corporation with tax losses became a transitory partner in a partner-

30. 2005 DTC 1731 (TCC), upheld by the Federal Court of Appeal, 2007 DTC 5146.

ship that was about to sell assets at a gain. The corporation was allocated a greater portion of the gain than its economic interest in the partnership warranted. Sec. 103(1) was applied and the income allocated to the corporation was reduced to the amount of its actual profit.

– *Penn West Petroleum Ltd. v. The Queen*.[31] Sec. 103(1) was applied to change a purported allocation of an item includible in income. An amount was allocated to a corporation that was considered by the court to be a transitory member of a partnership for the principal purpose of being allocated the particular item of income on a distribution of resource property to it in exchange for its partnership interest.

– *Kaulius v. The Queen*.[32] The Supreme Court of Canada ruled that the GAAR applied to a series of transactions in which a financial institution with a portfolio of mortgages with an accrued loss transferred the mortgages to a partnership and disposed of the partnership interest to unrelated investors who, under the rules in effect at the time, were able to claim the accrued loss as a partnership loss.

– *Ceco Operations Ltd. v. The Queen*.[33] The Tax Court of Canada found the GAAR to apply to a transfer of property to a partnership on a rollover basis under Sec. 97(2) where the transferors indirectly extracted funds that were the economic equivalent of receiving boot.

On the other hand, the courts have been fairly open to the use of partnerships in tax planning where the objective is the tax-efficient use of losses within a related group. In this regard, reference may be made to *Continental Bank of Canada v. The Queen*[34] and *Loyens v. The Queen*.[35]

10. Partnership Reporting

A partnership that carries on business in Canada or that is a Canadian partnership or a SIFT partnership at any time in the partnership's fiscal period is required to make an information return for that period in the prescribed form.[36] "Statements of Partnership Income" (information slips) indicating each partner's share of the income or loss of the partnership from various sources are also filed by the partnership, with a copy provided to each partner. The CRA assigns an identification number to the partnership for administrative purposes. Partners are required to file only the information slips with their tax returns. Partners are not required to file any further information, including financial statements.

Under the CRA's administrative policy, certain partnerships are not required to file. These include partnerships with five or fewer members throughout the fiscal period where no member is another partnership. If no return is required, it is nevertheless considered advisable to file a return because, in the absence of a filing, no limitation period applies with respect to the income of the partnership and its members may be open for reassessment indefinitely.

31. 2007 DTC 715 (TCC).
32. (*Sub nom Mathew v. Canada*), 2005 SCC 55 (SCC). To similar effect, see *OSFC Holdings Limited v. The Queen*, 2001 DTC 5471 (a companion case to *Kaulius* arising out of the same facts); and *The Queen v. MacKay*, 2008 FCA 105.
33. 2006 DTC 3006 (TCC).
34. 98 DTC 6505 (SCC).
35. 2003 DTC 355 (TCC).
36. Regulation 229. The prescribed form is Form T5013. The format and content of the information return are described in the T4068 Guide for the Partnership Information Return.

