TAX LETTER

April 2019

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TAXATION OF PARTNERSHIPS

General rules

A partnership is not considered a "person" or a "taxpayer" for most purposes of the Income Tax Act. As a result, a partnership does not file an income tax return or pay income tax.

Instead, the partners include their shares of the partnership's income or loss for the year (specifically, their taxation year in which the partnership's fiscal period ends). The percentages are usually determined under the partnership agreement.

In addition, the type of income (business income, income from property, etc.) generally flows through and is taxed as such to the partner. A partnership is therefore considered a flow-through entity (in contrast to a corporation, which is a taxpayer and pays tax on its income, and its after-tax income paid out as dividends to the shareholders is also subject to tax, with a dividend tax credit intended to offset the corporate tax).

The income (or loss) is included in the partner's income regardless of whether it remains in the partnership or is withdrawn as a partnership "draw". When the partner withdraws the income, there is no further income inclusion.

For each year in which there is an income inclusion, the amount so included is added to the partner's adjusted cost base of his or her interest in the partnership. This addition ensures that, where the income stays in the partnership and the partner sells his or her interest, there will not be double taxation. When the partner withdraws the income, the amount of the withdrawal is subtracted from the adjusted cost base of the interest.

Example

In year 1, a partner's share of the partnership income is $100,000. During the year, she withdraws $80,000 of this amount.

In year 2, her share of the income is again $100,000. During year 2, she withdraws $120,000.

In year 1, the partner will include in income the full $100,000 amount, even though she has not received the entire amount. The adjusted cost base of her interest in the partnership will increase by $20,000 ($100,000 inclusion net of $80,000 withdrawal).

In year 2, she will again include $100,000 in income. The $120,000 withdrawal will not be included in income. The adjusted cost base of her interest in the partnership will decrease by $20,000 (due to the $100,000 inclusion and $120,000 withdrawal).

Tax credits

Since the partnership is not a taxpayer and does not pay tax, it obviously cannot claim tax credits. Again, each partner will claim the credits that are available to the partner.
In some cases, the credit will relate to the actions of or donations made by the partnership. For example, if a partnership makes a charitable donation or political donation, each individual partner will claim a credit based on their share of the donation (again, the share will normally be determined by the partnership agreement or otherwise by the partners). The partner's share of the credit will reduce the adjusted cost base of his or her interest in the partnership.

Limited Partners

Special rules apply to limited partners of a partnership. In general terms, a "limited partner" under the Act includes a person whose liability as a partner is limited by operation of any law governing the partnership agreement (the definition is actually quite broad and can catch certain other partners). A limited partner for the purposes of these special rules does **not** include a member of a professional limited liability partnership (LPP), which include many law and accounting partnerships.

A limited partner's share of a loss from the partnership is limited to the partner's "at-risk amount" in respect of the partnership. As the name of the term implies, this amount is meant to reflect how much the partner actually has at risk in terms of the partner's investment in the partnership.

In basic terms, the at-risk amount at any time equals the partner's adjusted cost base in the interest plus the partner's share of the partnership income for the year accruing to that time, net of amounts owing by the partner to the partnership and any amount or benefit that the partner may receive for the purpose of reducing the impact of a loss of the partner's investment in the partnership.
The limited partner's share of the loss for the year in excess of the at-risk amount is not deductible in computing the partner's income for the year. The excess becomes a

"limited partnership loss", which can be carried forward indefinitely and deducted in future years, but again only to the extent of the partner's at-risk amount in those future years.

RESERVES FOR ACCOUNTS RECEIVABLE

Most businesses must use an accrual method in computing their business income for income tax purposes. An exception is made for certain taxpayers such as farmers or fishers, who can use a cash method.

Under the accrual method, a taxpayer carrying on a business must include amounts receivable in a year, even if they are not received in the year. In general terms, an amount is receivable where the taxpayer has an unconditional right to the amount in the year even though it is not due until a future year.

In some cases, a business of selling property (inventory) may deduct a reserve in respect of an amount receivable. The reserve, under Income Tax Act paragraph 20(1)(n), is allowed only if part or all of the proceeds of the sale are not due for at least two years after the date of sale, or in the case of real estate if all or part of the proceeds are due after the year of the sale.

The reserve in a year is limited to the portion that may "reasonably be regarded as a portion of the profit from the sale". Typically, this portion will equal:

gross profit on sale / total sales price
x amount still due

The reserve deducted in one year is added back into income in the next year. If another reserve is available in the next year, it can be claimed, and the process continues until proceeds are no longer due after the relevant year.

Example

RealCo is in the business of selling real estate. In year 1, it sells a property for $600,000, of which $200,000 is profit. One-third of the proceeds are due in each of years 1 through 3.

Year 1: RealCo includes the $200,000 profit in income. It can deduct a reserve of $200,000 / $600,000 x $400,000, or $133,333, for a net inclusion of $66,667.

Year 2: RealCo includes the $133,333 reserve from year 1, but can deduct a reserve of $200,000 / $600,000 x $200,000, or $66,667.

Year 3: RealCo includes the $66,667 reserve from year 2. No further reserve is allowed.

The reserve is available for a maximum of three taxation years, even if some of the proceeds are due after year 3. The reserve is optional.

Unfortunately, the reserve is not allowed for accounts receivable for services rendered.

RESERVES FOR CAPITAL GAINS

If you sell a property and have a capital gain, it must be reported for tax purposes even if some of the proceeds are due after the year of sale. One-half of the gain is included in income as a taxable capital gain.

However, similar to the situation discussed in the preceding section, a reserve is allowed by Income Tax Act subparagraph 40(1)(a)(iii) where some or all of the proceeds are due after the year of sale. In the case of capital gains, the reserve in a taxation year is the **lesser** of:

1) gain on sale x proceeds due after year / total proceeds on sale (conceptually, this is the portion of the gain that hasn't yet been received); and

2) The following fraction amount, depending on the year:

Year 1(year of sale): 4/5 of gain
Year 2: 3/5 of gain
Year 3: 2/5 of gain
Year 4: 1/5 of gain
Years 5 and future: No reserve

The reserve deducted in one year is added back the next year, and if still available, another reserve may be claimed in that year. Owing to the fraction amounts described above, no reserve is allowed after the fourth year, even if some proceeds are due after the fourth year. Put more simply, at least 20% of the gain must cumulatively be recognized each year for 5 years.

Example

In Year 1, you sell shares in a corporation for $500,000, resulting in a $100,000 capital gain. You receive $50,000 of the proceeds in Year 1. Another $200,000 proceeds are due in Year 2, and the remaining $250,000 is due in Year 3.

Year 1: You will report a $100,000 capital gain. You can claim a reserve equal to the lesser of:

1) $100,000 x $450,000 / $500,000 = $90,000 [since 90% of the proceeds haven't been received, you could postpone up to 90% of the capital gain under this rule], and
2) 4/5 of $100,000 = $80,000 [20% of the gain must cumulatively be recognized by each year].

Therefore, you can claim a reserve of $80,000, resulting in a net capital gain in Year 1 of $20,000. One-half of that, or $10,000, will be included in your income as a taxable capital gain.

Year 2: You will report the $80,000 reserve claimed in Year 1. You can claim a reserve equal to the lesser of:

1) $100,000 x $250,000 / $500,000 = $50,000 [since half of the proceeds haven't been received, you can still postpone up to half of the $100,000 capital gain under this rule, and
2) 3/5 of $100,000 = $60,000 [since 40% of the $100,000 must now be recognized, as it's the second year].

Therefore, you can claim a reserve of $50,000, resulting in a net capital gain of $30,000. One-half of that, or $15,000, will be included in your income as a taxable capital gain.

Year 3: You will report the $50,000 reserve claimed in Year 2. No further reserve is available. One-half of the $50,000, or $25,000, will be included in your income as a taxable capital gain.

The total taxable capital gain will be $50,000 (one-half of the initial $100,000 gain), but it will be spread out over the three years.

The reserve is optional. All or any of the available reserve may be claimed in each year.

EMPLOYEE LOANS

If you receive a loan from your employer with an interest rate below the “prescribed rate” of interest, you must normally include in your employment income an imputed interest benefit, under section 80.4 of the Income Tax Act.

The amount of the benefit to be included in your income for a taxation year is:

1) the prescribed rate of interest applied to the principal amount of the loan outstanding during the year, minus

2) any interest you pay on the loan in the year or by January 30 of the following year.

The prescribed rate of interest is set for each quarter of each year and is based on 90-day Federal treasury bill rates. For the first quarter of 2019, the rate was 2%. The amount of the benefit can therefore vary from quarter to quarter and year to year as the loan remains outstanding.

However, if the loan is a "home purchase loan", the prescribed rate of interest at the time of the loan is effectively a cap, serving as the maximum interest rate that will apply for each of the first five years of the loan. In other words, even if the prescribed rate increases in a subsequent quarter, the benefit for a year will be based on the lower prescribed rate that applied at the time of the loan. On the other hand, if the rate subsequently decreases below the prescribed rate at the time of the loan, such that the benefit in a year is lower than the benefit that would apply using the cap rate, then the lower rate will apply.

If the home purchase loan remains outstanding for more than five years, the new cap rate will be the prescribed rate at the five-year mark.

> **Example**
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> You receive a $200,000 interest-free home purchase loan from your employer on January 1, when the prescribed rate is 2%. The rate remains at 2% for the first two quarters but increases to 3% for the last two quarters of the year. You do not repay any of the principal.
>
> Your deemed benefit for the year will be capped at 2% of the principal amount of the loan, or $4,000.
>
> On the other hand, if the rate decreased to 1% for the last two quarters, your benefit for the year would be 2% x $200,000 x ½ (for first half of year) plus 1% x $200,000 x ½ (second half of year), totalling $3,000.

A home purchase loan is a loan used to acquire a dwelling in which you or a related person will live. It does not include a loan used to acquire a rental property to earn rental income.

SALE OF DEBT INSTRUMENT WITH ACCRUED INTEREST

If you own a debt instrument such as a bond, you will of course include the interest income from the instrument in your income for tax purposes. But what happens if you sell the debt before the next interest payment date, with accrued interest that you do not receive?

For income tax purposes, you must include the amount of interest that accrued up to the date of the sale. Typically, this is not problematic since the purchaser of the debt should compensate you for that interest by way of an increased purchase price (i.e. more than the debt's face value). However, since the purchaser will be required to include in income the full amount of interest to the next interest payment date, the purchaser can deduct the interest accrued to the time of purchase.

Example

You own a bond with a principal amount of $100,000, carrying an annual simple interest rate of 3%, payable on December 31 of each year. You sell the bond on June 30 for $101,500. The purchaser receives $3,000 of interest on December 31.

You must include $1,500 as interest income that you are deemed to have received. The purchaser will include $3,000 but can deduct the $1,500 that accrued to the time of sale, for a net inclusion of $1,500 of interest income.

The above example was straightforward, because the amount paid by the purchaser exactly equaled the principal amount of the loan plus the accrued interest. But typically, the value of the bond will fluctuate as market interest rates fluctuate. If market interest rates increase, the value of the bond will normally decrease. Conversely, if market interest rates decrease, the value of the bond will normally increase. As a result, on the sale of the bond, in addition to the included interest, you will usually have a capital gain or loss.

Example

Assume the same facts as above, except that market interest rates have decreased so that the value of your bond has increased. Accordingly, the purchaser pays you $102,000.

As above, you will include the $1,500 interest that accrued to the time of sale. The remaining $100,500 of proceeds ($102,000 net of $1,500 interest) will be your proceeds of disposition for capital gains purposes. Assuming your cost of the debt was $100,000, you will also have a $500 capital gain, and half of that, or $250, will be included in your income.

The purchaser's interest treatment will be as in the earlier example. The purchaser's cost of the debt will be $100,500 (the $102,000 paid net of the accrued interest to the time of sale).

DEBT FORGIVENESS RULES AND INSOLVENT CORPORATIONS

In the February 2019 Tax Letter, we discussed the debt forgiveness rules under section 80 of the Act. As discussed, when a debt used for income-earning purposes is forgiven or otherwise settled, certain tax attributes of the debtor are reduced, such as previous years' loss carryforwards and the tax costs of some properties. If some of the debt remains outstanding after the reduction of the tax attributes, one-half of the remaining amount is included in the debtor's income.

In the February Letter, we also noted that a debtor corporation can normally claim a reserve, which effectively allows it to spread out the income inclusion over five years, with a 1/5th inclusion each year.

However, another reserve may apply, under section 61.3 of the Act, if the debtor corporation is insolvent, or more particularly, where the remaining debt exceeds two times the corporation's net assets. (The net assets for this purpose are computed using a formula in the Act.)

In such case, the reserve deductible from the debt income inclusion is the amount by which the remaining debt exceeds twice the net assets. (In the extreme, if the net assets are zero or negative, the entire remaining debt can be deducted.) As noted by the Department of Finance in its explanatory notes to the provision, since the tax rate of a corporation does not exceed 50%, the net income inclusion after this reserve will not result in the corporation's liabilities exceeding the fair market value of its assets.

In practice, an insolvent corporation usually has losses and is no longer paying tax, so this reserve may not be of any use.

AROUND THE COURTS

Principal residence exemption denied for sale of "wood lot" adjacent to home

The principal residence exemption generally exempts part or all of the capital gain from the sale of your home, depending on how many years it was your "principal residence". In addition to your home, the land surrounding the building is included as your principal residence for this purpose if it can "reasonably be regarded as contributing to the use and enjoyment of the housing unit as a residence". Typically, your driveway and front and back yards qualify as part of your "principal residence".

However, if the surrounding land exceeds one-half hectare (about 1.24 acres), the excess will be considered part of your principal residence only if you can establish that the excess was *necessary* to contribute to your use and enjoyment of the housing unit.

In the recent *Makosz* case, the taxpayer bought a house on some land, and subsequently bought more of the surrounding land. The total land she owned exceeded one-half hectare. One part of the land, described as a "wood lot", contained trees which were cut down to provide wood. The taxpayer claimed that wood from the wood lot was necessary for heating her house, which had a wood heating system, an electrical system and a gas fireplace. She subsequently sold the wood lot at a gain and attempted to shelter the gain using the principal residence exemption.

The CRA denied the principal residence exemption. The CRA was of the view that the taxpayer had not established that the wood lot was necessary for her use and enjoyment of the house. Upon appeal to the Tax Court of Canada, the Court agreed. They determined that the lot was not necessary for her use and enjoyment since the wood could have been obtained elsewhere.

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