Tax Topics®

August 15, 2013
Number 2162

Wolters Kluwer CCH

DISPOSITIONS OF PARTNERSHIP INTERESTS — NAVIGATING THE AMENDMENTS TO SECTION 100 OF THE *INCOME TAX ACT*[1]

— *Jessica Fabbro, Tax Associate, Dentons Canada LLP, Vancouver*

In its 2012 Budget, the federal government implemented a number of changes to the taxation of partnership interests and their disposition. Some of the most significant changes were the proposed amendments to section 100 of the *Income Tax Act* (the "Act") with respect to the taxation of capital gains on the disposition of partnership interests to specified persons. The amendments are designed to prevent the conversion of recapture and other income gains on the assets of the partnership into capital gains through the disposition of the partnership interest instead.

Speaking generally, a taxpayer will hold a partnership interest as capital property, regardless of whether the partnership holds non-depreciable capital or inventory assets (or depreciable assets). That means that a partner can in essence convert income into capital gains by transferring inventory or depreciable assets to a partnership and then selling the partnership units.

Parliament knows that sort of conversion can take place, but the Act does not prevent it, presumably because at some point the partnership will sell the inventory and the then current partner will have to include the inventory gain in income, so all that is at stake is a deferral of the tax on the other 50% of the income rather than an exemption. Additionally, when one considers that the amount of gain potentially taxable may be doubled when the first partner rolled the inventory into the partnership and took back a partnership interest with a low adjusted cost base and high value, the deferral is relatively inconsequential.

Apart from section 100, however, the possibility exists that a partner could sell the partnership interest to a non-resident or a tax-exempt person. Under some circumstances, that new partner would not pay tax on the income allocated to him or her when the partnership sells the inventory. That would be too good to be true.

To prevent that, subsection 100(1) (prior to the proposed amendments) set out the calculation of a taxpayer's taxable capital gain on the disposition of an interest in a partnership where that partnership interest was disposed of to a person exempt from tax under section 149. His or her gain would be equal to (a) ½ of such portion of the taxpayer's capital gain as may reasonably be regarded as attributable to increases in the value of any property of the partnership that is capital property other than depreciable property, plus (b) the whole of the remaining portion of that capital gain. In other words, the proceeds were deemed to include 100% of the gain to the extent that the gain was attributable to depreciable assets held by the partnership, thereby replicating the tax effect the partner would have had had the partnership sold the depreciable assets and allocated the recapture to him or her.

Prior to proposed amendments, subsection 100(1) applied only to direct transfers of partnership interests, assuming the general anti-avoidance rule ("GAAR") did not apply. As such, the only due diligence a practitioner needed to do with respect to determining whether subsection 100(1) would apply was to inquire whether the purchaser was a tax-exempt entity. Consequently, a vendor could transfer its partnership interest indirectly to a tax-exempt entity by transferring it to a trust or partnership in which that entity was a beneficiary or partner and avoid the application of subsection 100(1) to the disposition. While the Canada Revenue Agency scrutinized these transactions to determine whether they were caught by any specific anti-avoidance provisions or under GAAR, the Department of Finance determined that legislative changes were necessary to limit the amount of tax leakage on the disposition of partnership interests.[2] The Department of Finance also noted that non-resident purchasers were being used to convert income gains on the assets of a partnership into capital gains through the disposition of the partnership interest instead and that dispositions to such persons should also be caught by subsection 100(1).[3]

As a result, subsection 100(1.1) was enacted to expand the categories of transferees that cause subsection 100(1) to apply on the disposition of an interest in a partnership. As of August 14, 2012, subsection 100(1) applies to dispositions of partnership interests to non-residents,[4] partnerships in which non-residents or tax-exempt entities are partners,[5] and trusts of which tax-exempt entities are beneficiaries,[6] as well as continuing to apply to dispositions to tax-exempt entities. The trust and partnership categories were added to prevent non-residents and tax-exempt entities from acquiring partnership interests indirectly through fiscally transparent entities. The application of subsection 100(1) to dispositions of partnership interests to non-residents is relatively straightforward. However, the amendments to include dispositions to certain trusts and partnerships are significantly more complex, particularly where the beneficiaries or partners of such entities are themselves partnerships or trusts.

Paragraph 100(1.1)(*c*) causes subsection 100(1) to apply where a vendor sells his or her interest in a partnership to another partnership and a tax-exempt entity[7] or a non-resident[8] has an interest in the purchasing partnership, regardless of the value of the interest such entity has in the purchasing partnership. Furthermore, subsection 100(1) will apply to the sale of a partnership interest to another partnership if any one of the purchasing partnership's partners is a trust that has a beneficiary that is either another trust or a tax-exempt entity and if the fair market value of the interests of those beneficiaries exceeds 10% of the fair market value of all of the beneficiaries' interests in the trust.[9] It is critical to note that if a trust has another trust as a beneficiary, and the interest of that beneficiary exceeds 10% of the fair market value of all of the beneficiaries' interest in the trust, and if the first trust has an interest in a purchasing partnership, then the purchasing partnership will be included in paragraph 100(1.1)(*c*) and the disposition will be subject to subsection 100(1), regardless of whether a tax-exempt entity is a beneficiary of the second trust.

The sale of a partnership interest by a taxpayer to another partnership will also be caught by paragraph 100(1.1)(*c*) if one or more partnerships has an interest in the purchasing partnership and any one of the entities referenced in subparagraph 100(1.1)(*c*)(i), (ii), or (iii) has an interest in that partnership, including an indirect interest through another partnership. In the case of stacked partnerships, this means that if any partner in the chain is a tax-exempt entity, non-resident, or trust meeting the conditions set out in subparagraph 100(1.1)(*c*)(iii), then the vending partner will be caught by paragraph 100(1.1)(*c*) and the disposition will be subject to subsection 100(1). As such, due diligence as to the ultimate owners of the purchaser partnership interests must be carried out where there are stacked partnerships, particularly as there is no minimum ownership threshold. This will be particularly difficult where the partnership is widely held and, even more so, where such partnership is publicly traded.

Similarly, paragraph 100(1.1)(*d*) deals with indirect acquisitions of partnership interests using trusts. It is important to note that paragraph 100(1.1)(*d*) includes trusts only where the beneficiaries are tax-exempt entities,[10] partnerships in which a trust or a tax-exempt entity has an interest and the fair market value of the interests exceeds 10% of the fair market value of all of the partners' interests in the partnership,[11] or trusts where one of the beneficiaries is either another trust or a tax-exempt entity and the fair market value of the interests of those beneficiaries exceeds 10% of the fair market value of all of the beneficiaries' interests in the trust.[12] However, paragraph 100(1.1)(*d*) does not include a trust merely because it has a non-resident beneficiary. While the Department of Finance Explanatory Notes do not explain the reason for this, one can only assume that it is because accrued income gains on the assets of a partnership cannot be avoided by a non-resident through the use of a trust, due to Part XII.2 tax.[13]

While the addition of paragraph 100(1.1)(*d*) is meant to prevent vendors from disposing indirectly of their partnership interests to tax-exempt entities and therefore avoiding subsection 100(1), paragraph 100(1.1)(*d*) is drafted such that it will include *any* trust that has a tax-exempt entity as a beneficiary. For example, a family trust in which one of the discretionary beneficiaries is a charity would be included under paragraph 100(1.1)(*d*), even if the trustees have never allocated any income to that beneficiary and have no intention of allocating income to that beneficiary. As noted above with respect to paragraph 100(1.1)(*c*), in the case of stacked trusts it may not matter whether any tax-exempt person has an ultimate interest in one of the trusts for the trust to be included under paragraph 100(1.1)(*d*). If the purchaser is a trust with a partnership as a beneficiary, for example, and another trust holds 10% or more of the fair market value of all the interests in the beneficiary partnership, then the purchaser trust will be included under paragraph 100(1.1)(*d*) and subsection 100(1) will apply to the vending partner, regardless of whether the second trust has any tax-exempt beneficiaries.

New subsections 100(1.2) and (1.3) set out two exceptions to the application of subsection 100(1). Subsection 100(1.2) sets out a *de minimis* exception where a taxpayer disposes of 10% or less of its partnership interest to a partnership or trust included under either paragraph 100(1.1)(*c*) or (*d*). Curiously, this *de minimis* exception does not apply where the 10% or less sale is directly to a non-resident or tax-exempt entity. This exception also does not apply where the purchasing trust is a discretionary trust with respect to either income or capital.

Subsection 100(1.3) applies where the purchaser of the partnership interest is a non-resident and partnership property is used, both immediately before and after the acquisition of the partnership interest, in carrying on business in Canada through a permanent establishment and that property represents 90% or more of the fair market value of all the assets of the partnership. It appears that this exemption was included because under Article XIII of Canada's income tax treaties, non-residents are taxed in the same manner as Canadian residents on income earned from the disposition of such assets. However, in its submissions on the 2012 Budget proposals, the Joint Committee noted that this exemption is unduly narrow and should be expanded to include all taxable Canadian property and non-depreciable capital assets, as non-residents would be taxed in the same manner as Canadian residents on the disposition of taxable Canadian property and the taxation of gains attributable to non-depreciable capital assets is not altered by subsection 100(1), so no tax leakage would occur.[14] Finance did not alter the amendments to take that suggestion into account. The Explanatory Notes for subsection 100(1.3) provide no guidance on why the exemption was limited in this manner.[15]

Additionally, the exception in subsection 100(1.3) is limited to direct acquisitions by non-residents. This means that if the purchaser is a partnership with a non-resident partner, this exception will not be available regardless of whether the asset conditions in paragraphs 100(1.3)(*a*) and (*b*) are met. The reason for this discrepancy is unknown; it would have been easy to expand the exception to "a person referred to in paragraph (1.1)(*b*) or subparagraph (1.1)(*c*)(ii)".

The purpose of the amendments to section 100 is clear: to prevent a taxpayer from avoiding an income inclusion by disposing of an interest in a partnership to non-residents or, indirectly, to tax-exempt entities instead of selling the assets of the partnership to such purchasers. However, it is questionable whether the amendments are the most effective way of achieving that purpose. As noted by Blanchet[16] and the Joint Committee, the limitations on the exceptions in subsection 100(1.2) and (1.3) appear to be arbitrary and are not in line with the harm the amendments are intended to prevent.

The amendments to subsection 100(1) and the addition of subsections 100(1.1) to (1.3)[17] are of critical importance to both tax practitioners and corporate lawyers, as significantly more due diligence must now be carried out. First, it must be ascertained whether the purchaser of the interest is a purchaser described in subsection 100(1.1). Where the purchaser is a partnership, practitioners must ensure that they look through the entity to determine whether *any* one of the partners is a non-resident, tax-exempt entity or trust. With respect to a trust, it is crucial for practitioners to remember that even if a tax-exempt entity is just one of many discretionary beneficiaries of the trust, this will cause the purchaser to be subject to paragraph 100(1.1)(*d*). Finally, practitioners must be cognizant of the limitations on the exemptions set out in subsections 100(1.2) and (1.3), remember that subsection 100(1.2) applies to acquisitions by non-discretionary trusts and partnerships only, and recall that subsection 100(1.3) applies to direct acquisitions by non-residents only — not to indirect acquisitions by non-residents through another partnership.

A number of tax lawyers from Dentons Canada LLP write commentary for CCH's Canadian Tax Reporter *and sit on its Editorial Board as well as on the Editorial Board for CCH's Canadian* Income Tax Act with Regulations, Annotated. *Dentons Canada lawyers also write the commentary for CCH's* Federal Tax Practice *reporter and the summaries for CCH's* Window on Canadian Tax. *Dentons Canada lawyers wrote the commentary for* Canada–U.S. Tax Treaty: A Practical Interpretation *and have authored other books published by CCH:* Canadian Transfer Pricing *(2nd Edition, 2011);*

Federal Tax Practice; Charities, Non-Profits, and Philanthropy Under the Income Tax Act; *and* Corporation Capital Tax in Canada. *Tony Schweitzer, a Tax Partner with the Toronto office of Denton's Canada LLP and a member of the Editorial Board of CCH's* Canadian Tax Reporter*, is the editor of the firm's regular monthly feature articles appearing in* Tax Topics.

For more insight from the tax practitioners at Dentons Canada LLP on the latest developments in tax litigation, visit the firm's Tax Litigation blog at http://www.canadiantaxlitigation.com/.

Notes:

[1] Joel Nitikman of Dentons Canada LLP, Vancouver, reviewed previous drafts of this article.

[2] Department of Finance, 2012 Federal Budget, Annex 4: Notice of Ways and Means Motion, paragraph 26.

[3] *Idem*, paragraph 24.

[4] Paragraph 100(1.1)(*b*).

[5] Paragraph 100(1.1)(*c*).

[6] Paragraph 100(1.1)(*d*).

[7] Subparagraph 100(1.1)(*c*)(i).

[8] Subparagraph 100(1.1)(*c*)(ii).

[9] Subparagraph 100(1.1)(*c*)(iii).

[10] Subparagraph 100(1.1)(*d*)(i).

[11] Subparagraph 100(1.1)(*d*)(ii).

[12] Subparagraph 100(1.1)(*d*)(iii).

[13] Blanchet, J., "Transactions Involving Interests in Partnerships", draft paper presented to the Canadian Tax Foundation's 63rd Tax Conference, 2012, at footnote 16.

[14] Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, "Re: August 14, 2012 Draft Legislative Proposals To Amend the *Income Tax Act* (Canada)," submission to Brian Ernewein, General Director, Tax Policy Branch, Tax Legislation Division, Department of Finance, September 13, 2012.

[15] Department of Finance, Explanatory Notes relating to the *Income Tax Act* and Regulations, August 14, 2012 at 23.

[16] See Footnote 13 above.

[17] The Department of Finance also added two anti-avoidance provisions in subsections 100(1.4) and (1.5). These provisions are not dealt with in this article, as they are in relation to the dilution, reduction, or alteration of a partner's interest in a partnership *other than* by way of a disposition for the purposes of avoiding the application of subsection 100(1). For further details on these rules, please see Kevin Yip, "Recent Legislation Affecting Partnerships and Foreign Affiliates — Subsection 88(1) and Section 100" in "Corporate Tax Planning," (2013), Vol. 61, No. 1, *Canadian Tax Journal*, 229.

PARTNERSHIP INTEREST — CALCULATION OF ADJUSTED COST BASE

The situation the Canada Revenue Agency (the "CRA") was asked to consider involved a partnership that suffered a loss on the disposition of shares of a corporation to another affiliated corporation. In the years preceding that disposition, the corporation whose shares were sold would have paid dividends on those shares to the partnership. The CRA was asked what the implications (if any) of subsections 40(3.4) and 112(3.1) of the *Income Tax Act* would be on the calculation of the adjusted cost base of the partnership.

The CRA noted that the above situation appeared to be a real situation and that a situation similar to one described above was already under review by the Rulings Directorate. Therefore, the CRA could not provide any specific comments on the above situation until the Rulings Directorate had completed its review. Presumably, once it has completed the review, it will provide its comments on the other situation through an advance ruling or technical interpretation that will be published. An English digest of that document will be published once content becomes available.

— External Technical Interpretation, International Operations Division, March 27, 2013, Document No. 2012-0449661E5

RECENT CASES

Trial judge justified in rejecting evidence regarding unreported income

The taxpayer was appealing a Tax Court decision that dismissed his appeal from the Minister's reassessments for 2003 to 2006 (2012 DTC 1210). The Minister assumed that bank deposits were unreported income, while the taxpayer claimed they were amounts of money given to him by his sister, as she submitted in a statutory declaration. The Tax