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DOCNUM 2014-0529981I7

REFDATE 141028

SUBJECT Allocation of partnership loss to a former partner

SECTION 96(1.01)

Please note that the following document, although believed to be correct at the time of issue, may not represent the current position of the CRA. Prenez note que ce document, bien qu'exact au moment émis, peut ne pas représenter la position actuelle de l'ARC.

PRINCIPAL ISSUES: (i) Does s. 96(1.01) dictate the allocation of a partnership's loss to a former partner? (ii) Do the debt forgiveness or debt parking rules apply?

POSITION: (i) No. (ii) No

REASONS: (i) Subsection 96(1.01) provides that a former partner is deemed to be a partner at the end of the partnership's fiscal period to enable the partnership to make an allocation to that former partner. Pursuant to subsection 96(1), an allocation to a partner continues to be the partner's share of the partnership income pursuant to the agreement between the partners. (ii) There was no settlement of the particular debt for purposes of the debt forgiveness rules and there was no "specified obligation" for purposes of the debt parking rules.

October 28, 2014

Basic Files Auditor HEADQUARTERS

XXXXXXXXXX TSO J. Gibbons

Attention: XXXXXXXXXX

2014-052998

XXXXXXXXXX (the "the Taxpayer")

This is in reply to your email dated May 2, 2014, concerning the application of subsection 96(1.01) of the Income Tax Act (the "Act") in the situation described below. In addition, you also enquired as to whether the debt forgiveness rules under section 80 of the Act or the debt parking rules under subsections 80.01(6) to (8) of the Act would apply in the particular circumstances.

FACTS

1. Prior to the series of transactions, XXXXXXXXXX (the "Trust") owned 100% of the Type A Units of XXXXXXXXXX (the "Partnership") while XXXXXXXXXX ("Parentco") owned 1 Type F Unit. The Type F Units were not entitled to any allocations. XXXXXXXXXX ("Parentco 1") and XXXXXXXXXX ("Parentco 2"), both resident in XXXXXXXXXX, were direct or indirect parents of Parentco.

2. The general partner is XXXXXXXXXX (the "General Partner"), which was owned by Parentco. Pursuant to section XXXXXXXXXX of the partnership agreement for the Partnership (the "Partnership Agreement"), the General

Partner is allocated XXXXXXXXXX% of the income or losses of the Partnership while the owners of the other limited partnership units are allocated the remaining XXXXXXXXXX% of the income or losses based on the proportion of limited partnership units held by them (other than Type F Units which do not entitled the owner to a share of the income or loss of the Partnership).

3. The Partnership was indebted to Parentco in the aggregate amount of $XXXXXXXXXX pursuant to a series of promissory notes issued between approximately XXXXXXXXXX and XXXXXXXXXX, and Parentco was indebted to the Partnership in the aggregate amount of $XXXXXXXXXX.

4. As at the "Effective Date," (defined as XXXXXXXXXX in the Purchase Agreement, which is described in Fact #5 below), the Partnership also owed $XXXXXXXXXX to Parentco 1 (the "Additional Debt") and $XXXXXXXXXX to Parentco 2 (the "Additional Loans").

Series of Transactions (in chronological order)

5. On XXXXXXXXXX, the "Purchasers," consisting of the Taxpayer and its parent, XXXXXXXXXX ("Holdco"), and the "Vendors," consisting of the Trust, Parentco, Parentco 1 and Parentco 2, entered into a purchase agreement (the "Purchase Agreement"). This agreement defined the "Closing Date" as the date on which all Regulatory Approvals were received and all other conditions precedent to Closing were satisfied or waived, or such other date as the Purchasers and Vendors might agree on.

6. Pursuant to Section XXXXXXXXXX of the Purchase Agreement, the Vendors and the Purchasers agreed to complete the following transactions prior to the Closing Date (defined in the Purchase Agreement as "Pre-Closing Transactions"):

a. The Partnership agreed to repurchase the 1 Class F unit owned by Parentco.

b. The Partnership and Parentco agreed to set off the debts referred to in Fact #3 above resulting in a net debt owing to Parentco in the amount

of $XXXXXXXXXX (the "Particular Loans").

c. The Partnership agreed to issue the following notes:

i. The First Note in the amount of $XXXXXXXXXX;

ii. The Second Note in the amount of $XXXXXXXXXX plus accrued interest from the Effective Date to the Closing Date to evidence the Additional Debt;

iii. The Particular Note in the amount of $XXXXXXXXXX to evidence the Particular Loans;

iv. The Third Note in the amount of $XXXXXXXXXX to evidence the Additional Loans.

d. Parentco agreed to sell the Particular Note to the General Partner in return for $XXXXXXXXXX and 1 common share of the General Partner.

7. Pursuant to the Purchase Agreement, the following transactions occurred on the Closing Date, which became effective at XXXXXXXXXX:

a. Holdco purchased the shares of the General Partner from Parentco;

b. The Taxpayer purchased the Type A Units from the Trust;

c. The Taxpayer purchased the First Note and the Second Note from Parentco 1; and

d. The Taxpayer purchased the Third Note from Parentco 2.

8. On XXXXXXXXXX, the General Partner (now owned by Holdco) sold the Particular Note to the Taxpayer for $XXXXXXXXXX.

9. The Partnership reported a loss of $XXXXXXXXXX for XXXXXXXXXX, of which XXXXXXXXXX% was allocated to the Taxpayer while XXXXXXXXXX% was allocated to the General Partner pursuant to the Partnership Agreement. At the end of XXXXXXXXXX, the Taxpayer owned all XXXXXXXXXX type A Units.

Your views

In your view, pursuant to subsection 96(1.01) of the Act, the Trust is required to report the portion of the Partnership's XXXXXXXXXX loss that relates to the period from the start of the Partnership's XXXXXXXXXX

fiscal period (i.e., XXXXXXXXXX) and ending at the time that the Trust sold its Type A Units to the Taxpayer (i.e., XXXXXXXXXX). You have calculated the amount of the partnership loss that should be allocated to the former partner by prorating the total net partnership loss by the proportion that the number of days in the partnership's fiscal period that the former partner was a member of the partnership is of the number of days in the fiscal period. Accordingly, you propose to reduce the Taxpayer's XXXXXXXXXX Partnership loss to $XXXXXXXXXX.

You have not yet proposed any reassessment with respect to debt forgiveness or debt parking as you are currently reviewing these issues. In your view, the debt forgiveness rules were circumvented by parking the debt in the Vendors via a series of transactions, thereby circumventing the grind on the loss of the Partnership. The benefit to the Vendors is that the partnership loss to the limited partner are not ground down, and the Purchaser gets the benefit of full amount of the undepreciated capital cost (the (UCC) of the assets of $XXXXXXXXXX.

The Taxpayer's Views

Our views

Subsection 96(1.01)

Subsection 96(1.01) of the Act provides as follows:

"If, at any time in a fiscal period of a partnership, a taxpayer ceases to be a member of the partnership

(a) for the purposes of subsection (1), sections 34.1, 101 and 103 and paragraph 249.1(1)(b), and notwithstanding paragraph 98.1(1)(d), the

taxpayer is deemed to be a member of the partnership at the end of the fiscal period; and

(b) for the purposes of the application of paragraph (2.1)(b), subsection 40(3.12) and subparagraphs 53(1)(e)(i) and (viii) and (2)(c)(i) to the taxpayer, the fiscal period of the partnership is deemed to end

(i) immediately before the time at which the taxpayer is deemed by subsection 70(5) to have disposed of the interest in the partnership, where the taxpayer ceased to be a member of the partnership because of the taxpayer's death, and

(ii) immediately before the time that is immediately before the time that the taxpayer ceased to be a member of the partnership, in any other case.

Paragraph 96(1.01)(a) provides that a former member is deemed to be a member of the partnership at the end of the partnership's fiscal period for the purposes of subsection 96(1), sections 34.1, 101 and 103 and paragraph 249.1(1)(b). Although paragraph 96(1.01)(a) of the Act allows an allocation to a former partner, it does not dictate the amount of the allocation. Under the rules in subsection 96(1) of the Act, the amount of income or loss of a partnership is allocated to members at the end of the partnership's fiscal period to the extent of the members' share. This share is generally based on a partnership agreement entered into between the partners. However, subsections 103(1) or (1.1) of the Act may apply to alter the allocation of partnership income, loss or other amounts. Subsection 103(1) of the Act applies where the principal reason for an agreement to allocate each member's share of income, loss or other amount may reasonably be considered to be the reduction or postponement of the tax that might otherwise have been or become payable under the Act. Where this provision applies, each member's share of income, loss or other amount, as the case may be, is deemed to be an amount that is reasonable having regard to all the circumstances including the

proportions in which the members have agreed to share profits and losses of the partnership from other sources or from sources in other places. Subsection 103(1.1) applies where two or more members of a partnership are not dealing with each other at arm's length and the agreement to allocate each member's share of income, loss or other amount, is not reasonable in the circumstances having regard to the capital invested or work performed for the partnership by the members or such other factors as may be relevant. Where this provision applies, each member's share is deemed to be an amount that is reasonable in the circumstances.
Question 46 of the Revenue Canada Roundtable of the 1985 Annual Conference of Canadian Tax Foundation addressed the allocation of partnership income to a partner who joins the partnership during the partnership's fiscal period:
"Q.46 Interest Acquired Partway Through Year

What is Revenue Canada's view regarding the share of the income or loss of a partnership that should be allocated to a partner who acquires his partnership interest partway through the partnership's fiscal year?

Department's Position

Subject to the comments contained in paragraph 20 of Interpretation Bulletin IT-138R, dated January 29,1979, with respect to losses allocable to limited partners, the income or loss of any partner for income tax purposes in respect of a particular year of partnership operations will be his share of the partnership's income or loss allocated to him pursuant to the partnership agreement, notwithstanding the fact that he may not have been a partner throughout the whole of the fiscal period of the partnership.

The above comments address bona fide situations—that is, where a partner is acquiring an interest with a view to becoming an ongoing member of the partnership."

It is a question of fact having regard to all of the particular circumstances whether subsection 103(1) or (1.1) would apply to reallocate the Partnership's XXXXXXXXXX loss. However, based on the information provided, it is our view that this situation appears to fall within the parameters of the Roundtable Question described above. Therefore, the allocation made to the Taxpayer for the fiscal year in question does not appear to be unreasonable in the circumstances as the Taxpayer continued to be a partner in the Partnership in subsequent years.

Debt Forgiveness and Debt Parking

Pursuant to subsection 80(3) of the Act, the debt forgiveness rules apply where a "commercial obligation issued by a debtor is settled at any time." Based on the facts outlined above, there was no settlement of the Particular Note and thus section 80 of the Act would not apply to this debt. You have also asked whether the debt parking rules in subsections 80.01(6) to (8) of the Act, which may result in a deemed settlement of a "specified obligation," would apply. The debt parking rules are designed to counter the parking of a commercial debt obligation that would otherwise effectively circumvent the debt forgiveness rules.

In general terms, paragraph 80.01(8)(a) of the Act provides that where a commercial debt obligation that was issued by a debtor becomes a "parked obligation" at any particular time and the specified cost at the particular time to the holder of the obligation is less than 80% of the principal amount of the obligation, the obligation shall deemed to be settled at the particular time. One of the conditions under the

definition of a "parked obligation" in subsection 80.01(7) of the Act is that the obligation be a "specified obligation." This latter term is defined in subsection 80.01(6) as follows:

"For the purpose of subsection (7), an obligation issued by a debtor is, at a particular time, a specified obligation of the debtor where

(a) at any previous time (other than a time before the last time, if any, the obligation became a parked obligation before the particular time),

(i) a person who owned the obligation

(A) dealt at arm's length with the debtor, and

(B) where the debtor is a corporation, did not have a significant interest in the debtor, or

(ii) the obligation was acquired by the holder of the obligation from another person who was, at the time of that acquisition, not related to the holder or related to the holder only because of paragraph 251(5)(b); or

(b) the obligation is deemed by subsection 50(1) to be reacquired at the particular time. Based on the facts, it does not appear that the Particular Note was a specified obligation at any time. In this regard, at no time did the various owners of the Particular Note deal at arm's length with the debtor (i.e., the Partnership). Further, with respect to subparagraph 80.01(6)(a)(ii), at both times that the Particular Note was acquired by another person (i.e., Facts #6(d) and #8), that other person was related to the holder of the Particular Note. Accordingly, this latter provision would also not apply in the circumstances. Since the Particular Note was never a specified obligation, the debt parking rules would not apply.

General Anti-Avoidance Rules ("GAAR")

With regard to your question about whether GAAR applies, we note that you have referred this file to Aggressive Tax Planning for their review. You may find it useful to refer to the Tax Court of Canada's decision in

Pièces Automobiles LeCavalier Inc. v. The Queen, 2013 DTC 1245, which contains a discussion of the object and spirit of the debt parking rules and supports the application of GAAR in a situation where the debt parking rules in subsections 80.01(6) to (8) were considered to have been misused or abused.

For your information, a copy of this memorandum may be severed using the Access to Information Act criteria and placed in the Canada Revenue Agency's electronic library. Such a severed copy would also be distributed to the commercial tax publishers for inclusion in their databases. The severing process would remove all material that is not subject to disclosure, including information that could disclose the identity of the taxpayer. Should your client request a copy of this memorandum, they could be provided with the electronic library version, or they may request a severed copy using the Privacy Act criteria, which does not remove client identity. You should make requests for this latter version to Ms. Celine Charbonneau at (613) 952-1361. A copy would be sent to you for delivery to the client.

We trust that these comments will be of assistance.

Yours truly,

G. Moore
for Director
International Division
Income Tax Rulings Directorate
Legislative Policy and Regulatory Affairs Branch

c.c. Suzanne Saydeh, Aggressive Tax Planning, Audit Directorate, Head Office