The Joint Committee on Taxation of
The Canadian Bar Association
and
Chartered Professional Accountants of Canada

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Brian Ernewein
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Dear Mr. Ernewein:

Subject: Joint Committee Submission – Response to *Green* case

In *Green v. R.*, 2017 FCA 107, the taxpayers were limited partners of a partnership ("Top Partnership") which was itself a limited partner of a number of subsidiary partnerships ("Bottom Partnerships"). The Bottom Partnerships incurred losses each year from 1996 to 2008. For those years, the at-risk amount of each of the taxpayers in the Top Partnership was nil, and they did not report any losses relating to the Bottom Partnerships. In 2009, the Top Partnership realized income, with the result that the at-risk amount of the taxpayers in the Top Partnership became positive. The taxpayers then attempted to claim their share of the Bottom Partnership losses, to the extent of their at-risk amounts in Top Partnership.

The CRA denied the losses on the basis the denied losses were losses of the Bottom Partnership, and there was no mechanism in the *Income Tax Act* (the "Act") to allow such denied losses to be claimed by a taxpayer in a tiered partnership structure. Effectively, such losses were a "tax nothing" based on the CRA's position.

To avoid that result, which seemed to the Court to be inappropriate from a policy perspective, the Court held that at least certain portions of section 96 of the Act do not apply to partnerships. Although that finding avoided the inappropriate result that would have arisen in *Green* had the CRA's position prevailed, we believe that, applied broadly, that finding could lead to inappropriate results in other contexts. At our meeting in November we discussed this case, and offered to provide our thoughts on what factors the Department should take into account if it proposes a legislative response to the decision. This submission sets out our initial thoughts in this regard. We would be pleased to engage with you further if you would consider that to be useful.

We recommend that any legislative response to *Green,* taken to resolve potential anomalies that could flow from that decision, also should avoid provisions resulting in the inappropriate denial of limited partnership losses that the court clearly found to be unacceptable in interpreting the existing provisions (or introducing other inappropriate results). Our perspective is that the litigation in *Green* arose from CRA's position that limited partnership losses incurred by a lower tier partnership in a tiered arrangement

are never deductible by any taxpayer. We believe that a measured approach would result in legislation that gives effect to the policy underlying the at-risk rules without creating artificial limitations on the deduction of partnership losses where that policy is not offended. Tiered partnerships may be implemented in many situations for *bona fide* reasons and, in our view, these rules can and should operate in effectively the same manner, whether or not there is more than one level of partnerships.

One approach the Department of Finance may consider would be to amend the Act to provide that all portions of section 96 apply to partnerships where such partnerships are members of lower-tier partnerships. While this approach appears to have some appeal, we are concerned that it could give rise to unintended consequences and therefore would require careful consideration and review. We would be happy to engage with you in that regard if that is the Department's preferred approach.

Alternatively, the Department may choose to adopt a narrower approach intended solely to clarify that the at-risk rules apply through tiered partnerships. Whichever approach the Department chooses, we recommend that it preserve the ability to carry over unused limited partnership losses to future years in which the upper-tier partnership has an amount at risk in respect of the lower-tier partnership. For example, a provision similar to paragraph 111(1)(e) of the Act could be added to allow partnerships to claim a deduction in computing their income or loss in circumstances similar to the circumstances where a taxpayer would be allowed a deduction in computing taxable income under paragraph 111(1)(e) of the Act.

In addition, we have encountered other anomalies in the application of the at-risk rules, and certain other rules, that, in our view, could usefully be addressed as part of a response to the *Green* decision. These anomalies are described below.

1. Insufficient Income

Where a limited partner ceases to be a limited partner at a time at which it has a positive at-risk amount, but does not have sufficient income to fully utilize the available limited partnership losses, there is no mechanism to allow the excess limited partnership losses to be carried forward and claimed in future years. In our view, such a mechanism would be consistent with the intent of the at-risk rules, and the Act more generally.

2. Conversion to General Partnership Interest

Where a limited partner ceases to enjoy limited liability by converting his or her interest into a general partnership interest or acquiring a general partnership interest, at a time when the partner has unused limited partnership losses, arguably the partner cannot subsequently claim the limited partnership loss even to the extent the partner subsequently becomes at risk due to allocations of income from or investments made in the partnership. We recommend that the Act be amended to provide that a limited partner “or former limited partner” has an at-risk amount, such that a limited partner “or former limited partner” clearly would be entitled to deduct limited partnership losses in computing taxable income to the extent of that at-risk amount pursuant to paragraph 111(1)(e).

3. Transfer of Interest

Limited partnership losses are an attribute of a particular partner and, as such, may be eliminated on a transfer of a partnership interest. This is the case whether the transfer is arm's length, non-arm's length or involuntary (e.g., on death). In our view, it would be appropriate to allow limited partnership losses to be available to at least certain successor partners at times at which the successor has an at-risk amount. For example, non-arm’s length transfers, or at least transfers as a consequence of death, could be accommodated. There also may be merit in allowing transfers in arm’s length circumstances, although in

that case we believe it would be appropriate to carefully consider whether restrictions on loss carryforwards similar to those in section 111 of the Act should be imposed.

Subsection 40(3.1) and ACB Adjustment Timing Mismatch

We also believe that this would be an opportune occasion to revisit one aspect of the rule in subsection 40(3.1) of the Act deeming certain partners to realize a gain where, at the end of a fiscal period of a partnership, they have a "negative ACB" in respect of their partnership interest. The time at which subsection 40(3.1) is applied differs from the time at which ACB is adjusted for income or loss, such that a deemed gain can arise simply as a result of ordinary course distributions of income during a year. We understand the Department's objective in preventing limited partners from having negative ACB in their partnership interests as an ongoing matter. However, it is not at all unusual for a partnership to earn income or realize gain in a year in an amount such that one or more partners' share of that income or gain is more than its ACB at that time. If the amounts required to be added to a partner's ACB in respect of such income or gain at the beginning of the next fiscal period are taken into account, no negative ACB would be expected to arise. In our view, allowing such income or gain to be taken into account is not difficult, or subject to manipulation. The consequences of the present rule include needlessly and unproductively deferred distributions, unnecessary expenses incurred on "work-around" solutions and unwary taxpayers becoming subject to potential taxation in respect of phantom gains.

Although subsection 40(3.12) somewhat addresses this situation, it is not an ideal solution for several reasons. First, that solution adds needless administrative costs for taxpayers and the CRA by requiring reporting of gains and offsetting losses by partners (potentially in different years) where it applies. Second, that solution adds needless complexity to the Act, including modifications to the definition of "capital dividend account" in subsection 89(1) to prevent perceived abuse. Third, that solution is not effective in tiered partnership structures.

For these reasons, it seems to us that to the extent that the gain that would arise under subsection 40(3.1) does not exceed current year income or gain, there is neither an integrity issue nor a revenue issue at stake.

As you are aware, a version of this relief was provided for professional partnerships, as defined in subsection 40(3.111) of the Act, effective November, 2001. In our view, it would be appropriate to extend the effect of this provision so that it applies more generally where subsection 40(3.1) is relevant. We would be pleased to discuss this matter with you further if that would be of assistance.

The Joint Committee would like to acknowledge the significant contributions of the following individuals in the preparation of this material.

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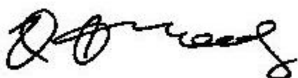
Yours very truly,



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