CHAPTER 15

PARTNERSHIPS

Review Questions

1. Identify three "non-taxable entities." Does "non-taxable" mean that the income earned by these entities is not subject to tax? Explain.

2. What is a standard partnership? How is it different from a joint venture and from a co-ownership?

3. What types of entities can be partners in a standard partnership? Does each partner in a partnership have to be the same type of entity? Explain.

4. Must each partner in a partnership contribute an amount of capital that is proportionate to its profit-sharing ratio? Explain.

5. To what extent is each partner liable for the obligations of the partnership? Compare this with the obligations of shareholders in a corporation.

6. How can a partner that has a substantial net worth organize its investment in a partnership so that its liability exposure is limited?

7. "The amount of tax paid on partnership profits depends on the nature of the separate partners and not on the nature of the partnership itself." Explain.

8. "Profits of a partnership are included in the income of the partners only when those profits are distributed to them." Is this statement true? Explain.

9. A partnership may be preferable to a corporation when the business venture is new and expects to incur losses in its early years. Explain why.

10. When net income from business for tax purposes is being determined, the timing of certain expense deductions is discretionary. For example, a taxpayer may claim all of, some of, or none of the available capital cost allowance. Similarly, the deduction of certain reserves is discretionary. In a partnership structure, is the deduction of discretionary items decided by the partnership as a whole, or can each partner make a separate decision on its proportionate share? What conflict can arise as a result?

11. "Partnership profits or losses allocated to the partners retain their source and characteristics." What does this mean? How does this compare with the manner in which a corporation's profits or losses affect its shareholders?

12. On distribution, for tax purposes, accumulated partnership profits to partners are treated differently from accumulated corporate profits to shareholders. How?

13. What is a partnership interest? What type of property is it considered to be for tax purposes?

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14. The value of the shares of a corporation changes when corporate profits or losses are accumulated and when corporate assets change in value. The value of a partnership interest changes in exactly the same manner. Explain how the tax treatment applied to the sale of a partnership interest differs radically from that applied to the sale of corporate shares.

15. Explain the general tax implications, both to the partner and to the partnership, when a partner transfers property to the partnership that has appreciated in value beyond its cost amount. Is there an alternative treatment? Explain.

16. “A Canadian-controlled private corporation that earns $100,000 from its own active business plus an additional $400,000 from its 50% interest in a business partnership is entitled to apply the small-business deduction to its combined income of $500,000.” Is this statement correct? Explain.

17. Identify four factors that managers must consider when deciding whether a new business venture with other parties will be organized as a partnership or as a corporation.

18. An investor may be able to afford to lose more money from a failed business venture if it is organized as a partnership, rather than a corporation. Explain why.

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Solutions to Review Questions

R15-1. Partnerships, limited partnerships, and joint ventures are all referred to as non-taxable entities. The reference to "non-taxable" does not mean that the income of each entity is not subject to tax, but rather refers to the fact that the entities themselves are not directly liable for the tax on the income earned. Instead, the income from these entities is allocated, for tax purposes, directly to their owners who are liable for the tax.

R15-2. A partnership is the relationship that exists between entities that carry on a business in common with a view to profit. It implies a continuing relationship or going concern. In contrast, a joint venture (which also involves a group of entities carrying on a business activity together) is usually formed for a single purpose or transaction and, therefore, suggests a common activity for a narrow purpose and limited duration. A co-ownership refers to the joint ownership of property by several parties (for example, a unit of investment real estate is often owned by several individuals).

R15-3. A partner in a standard partnership can be any type of entity. Normally, the partners are either individuals or corporations, although other entities such as trusts or other partnerships may also be partners. There is no requirement that the type of partners be the same. In other words, an individual, a trust, and a corporation can form a partnership.

R15-4. The contribution of capital by each partner is not the sole basis for determining the profit sharing ratio of the partnership. A partner can participate in a partnership and share profits by contributing capital (money or other property), effort, or a combination of capital and effort. Therefore, a partner may share in profits by providing special expertise or greater management effort even though their financial contribution is non-existent or substantially less than other partners.

R15-5. Each partner is fully liable for all debts and obligations of the partnership. This means that each partner's liability exposure not only goes beyond the amount of their invested capital but may also go beyond their proportionate share of partnership involvement. A partner with a 10% partnership interest may be liable for 100% of the partnership's obligations if the other partners are unable to meet their proportionate commitment. In contrast, shareholders of a corporation are normally at risk only to the extent of their capital invested in the corporation's share capital.

R15-6. A proposed partner that has a substantial net worth can limit its liability exposure from the partnership by organizing a limited value separate corporation to act as the partner. For example, if the required partnership contribution is $100,000, the proposed partner can first contribute $100,000 to his or her holding corporation. The corporation, in turn, becomes the partner by contributing $100,000 to the partnership. As a result, the corporate partner has the full risk exposure but because its net worth is only $100,000, the risk is effectively limited to that amount. [S.96(2.4), 96(2.2)]

R15-7. As the partnership entity is not liable for tax, its earned income is allocated proportionately to the partners for inclusion in their income for tax purposes. Consequently, the amount of tax paid on partnership profits is dependent, in part, on the nature of the partners. For example, if one partner is a corporation and the other an individual, the allocation of business income to each may be subject to different rates of tax. The corporate partner may be able to use the low rate of tax as a result of the small business deduction on some, or all, of its share of the business profits. A second level of tax will also be incurred when those profits are distributed to the corporate partner's shareholders. On the other hand, the

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individual partner will be subject to tax at his or her personal marginal rate.

R15-8. The statement is not true. Partnership profits are allocated to the partners on the last day of the partnership's fiscal year regardless of whether or not such profits have been distributed. It is conceivable then that a partner may be liable for the full tax liability on its share of income even though the income is retained in the partnership for reinvestment. [S.96(1)]

R15-9. A new venture that is expected to incur losses in its early years and is organized as a partnership allocates those losses to the separate partners as they are incurred. Consequently, the partnership losses can be offset against the other income of each partner creating additional immediate cash from the reduction of taxes otherwise payable on other income. This additional cash flow can be used by the partners to assist the funding requirements of the new venture (i.e., its losses) thereby increasing its chances of success. If the new venture was organized as a corporation, the losses would remain unused until the new venture was profitable, and the cash flow advantage from reduced taxes would be delayed.

R15-10. In a partnership structure, the application of discretionary items such as capital cost allowance, reserves, and method of inventory valuation must be determined and applied by the partnership entity before profits or losses are allocated to the partners. Therefore, each partner cannot make separate decisions with respect to their share of such items. In some circumstances this creates conflict. For example, a partner that has significant losses from other non- partnership activities may want to maximize the partnership profits (e.g., by not claiming capital cost allowance) whereas another partner who has income from other sources would want to minimize the partnership profits. [S.96(1)(c)]

R15-11. Profits or losses allocated to partners retain their source and characteristic. This means that the different types of income earned by the partnership (business income, capital losses and so on) are allocated in the same form to the partners. Therefore, a capital gain earned by a partnership, when allocated, is a capital gain to the partner. In effect, the partnership is a conduit that earns different types of income but then passes it on to the partners as if it was earned directly by them. In contrast, a corporate structure changes the nature of its income when it is passed on to the shareholder. Business income earned by a corporation, once taxed, is paid to the shareholder as a dividend and, therefore, constitutes property income for the shareholder. [S.96(1)]

R15-12. Profits earned and retained by the partnership become part of the partners' capital or equity and can be distributed whenever the partners decide to do so. The distribution of accumulated profits constitutes a return of capital and does not constitute the receipt of income when received by the partners. In comparison, the corporate entity accumulates its after-tax profits as retained earnings and when distributed becomes a taxable dividend to the shareholder.

R15-13. A partner's equity position in a partnership is referred to as a partnership interest for tax purposes. A partnership interest exists whenever a party has rights and obligations as defined by the partnership agreement. For tax purposes, a partnership interest is considered to be capital property to the partner if it was acquired for the purpose of providing a long-term benefit to the owner. Therefore, any gain or loss on disposition results in a capital gain or loss.

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R15-14. Similar to the sale of corporate shares, the sale of a partnership interest may result in a capital gain, if its proceeds of disposition exceed its adjusted cost base, or a capital loss, if the cost base exceeds the proceeds of disposition. However, the sale of a partnership interest will not create a capital gain or loss to the extent that its value has been affected by profits retained in the partnership or losses incurred by the partnership. Capital gains or losses occur only to the extent that the individual assets owned by the partnership change in value. [S.100(2),(4)]

The above concept is achieved by an arbitrary annual adjustment to the adjusted cost base of the partnership interest. The ACB is automatically increased by the profits earned by the partnership and allocated to the partners. Therefore, if profits are retained, the value of the interest increases but so does the ACB by an equivalent amount. Similarly, the withdrawal of profits by the partner reduces the value and the ACB. A loss incurred by the partnership has the reverse effect. [S.53(1)(e), 53(1)(c)]

In comparison, a corporate share increases in value when profits are retained but there is no corresponding adjustment to the ACB. And a capital gain will result with respect to that value when the shares are sold.

R15-15. A partnership, although not a taxable entity, is considered to be a separate entity for purposes of holding property. Consequently, if a partner transfers property to the partnership, either as a sale or as a capital contribution, the partner is deemed to have sold the property at its fair market value. If the property's value is greater than the partner's cost amount, taxable income will be created. The partnership acquiring such a property has a cost for tax purposes equal to the property's fair market value. As an alternative, the partner can choose, by means of an election, to transfer the property for tax purposes at the partner's cost amount. This will eliminate taxable income to the partner, but the cost of the property to the partnership is based on the elected amount and not its fair market value. [S.97(1),(2)]

R15-16. The statement is not correct. It is true that a CCPC is entitled to the small business deduction on $500,000 of its active business income. However, the amount of income allocated from a partnership that is eligible to be applied to the limit is restricted. Only the first $500,000 of partnership active business income qualifies for small business deduction eligibility by the corporate partners. The question indicates that the corporate partner's 50% share of partnership profits is $400,000. Therefore, of that amount only $250,000 (50% of the partnership's $500,000 limit) is eligible for the small business deduction provided that the corporate partner has not used up its $500,000 limit. In this case, the CCPC can claim the small business deduction on:

Its own profits	$100,000
Partnership profits	250,000
	$350,000

This indicates that the CCPC could have earned an additional $150,000 from its own activities which would have qualified for the small business deduction. [S.125(1)(a)(ii), 125(2)]

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R15-17. The four factors to be considered when deciding between a partnership and a corporation for a new venture are as follows:

- What will be the tax cost on annual profits from the new venture?
- How can anticipated operating losses, if any, be utilized against other sources of income from either the new venture itself or the participants?
- What are the tax implications if the new venture fails and the participants lose all or a portion of their invested funds? In other words, what is the after-tax cost of the loss?
- How can the invested capital and future profits be returned to the participants with the minimum amount of tax?

R15-18. An investor in a failed business venture can afford to lose more money if it was organized as a partnership rather than a corporation because the partnership structure permits the investor to recover a greater amount of tax savings and at an earlier time. For example, a taxpayer in a 45% tax bracket that loses $100,000 from an investment in corporate shares will suffer a capital loss of which only 1/2 is allowable at the time the shares are sold or when the corporation is insolvent. Assuming the capital loss can be used, the after-tax loss will be $77,500 ($100,000 - 45% [1/2 of $100,000]). However, under a partnership structure, the $100,000 loss would take the form of business losses allocated from the partnership thereby allowing tax savings on the full $100,000. The after-tax partnership loss would be only $55,000 ($100,000 - 45% of $100,000). Therefore, the partnership could have lost $140,909 before tax leaving an after-tax loss of $77,500 ($140,909 - 45% of $140,909) which is the same as the $100,000 loss incurred on the corporation structure.

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Key Concept Questions

QUESTION ONE

Jennifer Black and Kryan White carry on a security service business through a partnership. Jennifer and Kryan are both active in the business and share profits equally. In the current year they each receive a salary of $40,000 from the partnership.

Black & White Partnership
Income Statement
For the year ended December 31, 2022

Income:	
Security service fees	$200,000
Gain on sale of public company shares	12,000
Eligible dividends	10,000
Interest income	3,000
	225,000
Expenses:	
Office rent	15,000
Capital cost allowance	8,000
Salaries paid to staff	30,000
Salaries paid to partners	80,000
Donations to registered charities	2,000
	135,000
Net income	$ 90,000

Compute net income for tax purposes for the partnership.

CPA Competency 6.3.2 Income taxes payable for an individual – Partnership income flow-through. Income Tax Act reference: ITA 96(1)(a), (b), (c).

QUESTION TWO

Jennifer Black is single and lives alone. Her sole source of income is from the Black & White Partnership (see Question One).

Compute Jennifer's net income, taxable income and federal tax payable for the current year.

CPA Competency 6.3.2 Income taxes payable for an individual. Income Tax Act reference: ITA 96(1)(f); 117, 118(1(c), 118.1(3),(8), 121.

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QUESTION THREE

A Ltd. and B Ltd. are partners in the Triple M partnership. A Ltd. and B Ltd. share equally in the income or loss of the partnership annually. The partnership earned business income of $100,000 and $300,000, respectively, for its years ended June 30, 2022 and June 30, 2023. Income from the Triple M partnership is A Ltd.'s only source of income for its year ended December 31, 2022. In 2021, A Ltd. accrues, and includes in income, $20,000 of stub period partnership income.

Determine the amount of business income to be reported for tax purposes by A Ltd. for its year ended December 31, 2022.

CPA Competency 6.2.2 Taxes payable for a corporation – Reconciling income. Income Tax Act reference: ITA 34.2(2), 96(1)(f).

QUESTION FOUR

Tomas Mejia, Mari Ryan, and Chris Bolton are partners in the TMC Partnership. Tomas is the only partner who is involved in the daily activities of the partnership and, thus, the partnership agreement stipulates that 70% of the partnership business income and losses will be allocated to Tomas; the remaining 30% will be shared equally by Mari and Chris. The three partners share equally in all other sources of partnership income. For the current year the TMC Partnership had the following sources of income (losses):

Business income	$400,000
Rental loss	(30,000)
Interest income	9,000
Taxable capital gains	21,000
Allowable capital losses	(15,000)
	$385,000

The partnership did not distribute any of the current year profits to the partners.

Prepare a chart showing the allocation of the income (losses) to the partners for tax purposes.

CPA Competency 6.3.2 Income taxes payable for an individual – Partnership income flow-through. Income Tax Act reference: ITA 96(1)(f), (g).

QUESTION FIVE

Canadian partnerships are required to file an annual information return (T5013).

What information must be included with the T5013, and when is the filing deadline?

CPA Competency 6.4.1 Adherence to compliance requirements Income Tax Act reference: ITA 233(1); Reg 229(1), (5).

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QUESTION SIX

In March of Year 1, Sally Rogers and Peter Dean began a business partnership. Each contributes cash of $75,000 and agrees to share income and losses equally. The following information is provided for the first fiscal year of the partnership.

a) The partnership net income of $328,000 consisted of the following sources of income:

Business income	$300,000
Eligible dividends	20,000
Taxable capital gains	10,000
Allowable capital losses	(2,000)
	$328,000

b) In addition, the partnership received a tax-free capital dividend of $12,000 and donated $3,000 to registered charities.

c) Each partner takes draws totaling $60,000.

Determine the adjusted cost base for the partnership interest of each of the partners at January 1, Year 2.

CPA Competency 6.3.2 Income taxes payable for an individual. Income Tax Act reference: ITA 53(1)(e), 53(2)(c).

QUESTION SEVEN

Lindsay Shaw is a partner in a Canadian partnership. On April 30th of the current year, she transferred title of a piece of land that she held as a capital asset to the partnership in exchange for cash of $40,000. The land is valued at $100,000 at the time of the transfer. Lindsay paid $40,000 for the land when she purchased it several years ago.

Determine the tax consequences resulting from the transfer of title to the land to the partnership.

Income Tax Act reference: ITA 97(1).

QUESTION EIGHT

Reconsider the scenario in Question Seven. Assume that Lindsay and her partners made a joint tax election choosing to transfer the land to the partnership at its tax value ($40,000).

Determine the tax consequences resulting from the transfer of the title to the land to the partnership under this assumption.

Income Tax Act reference: ITA 97(2).

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Solutions to Key Concept Questions

KC 15-1

[ITA: 96(1)(a), (b), (c) – Partnership net income]

The amount of income earned or losses incurred by the partnership is determined as if the partnership were a separate taxable entity.

Partnership net income for tax purposes:

Business income:		
Financial statement income	$ 90,000	
Add: Salaries paid to partners	80,000	
Donations to registered charities	2,000	
Subtract: Capital gain	(12,000)	
Dividend income	(10,000)	
Interest income	(3,000)	$147,000
Property income:		
Eligible dividends	$10,000	
Interest income	3,000	13,000
Taxable capital gains ($12,000 x ½)		6,000
Net income for tax purposes		$166,000

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KC 15-2

[*ITA 96(1)(f); 117, 118(1(c), 118.1(3),(8), 121* – partnership income retains its source when allocated to partners]

Employment income			$ 0
Business income ($147,000 x 50%)			73,500
Property income:			
Eligible dividends ($10,000 x 50% x 138%)			6,900
Interest income ($3,000 x 50%)			1,500
Taxable capital gain ($6,000 x 50%)			3,000
Net income			$84,900
Taxable income			$84,900
Federal tax:			
On the first	$50,197 x 15%		$ 7,530
On the remainder	34,703 x 20.5%		7,114
			14,644
Federal non-refundable tax credits:			
Basic personal amount	$14,398 x 15% = $(2,160)		
Donation credit	$200 x 15% = $ 30		
	800 x 29% = 232	(262)	
Dividend tax credit	($5,000 x 38% x 6/11)	(1,036)	(3,458)
Federal tax payable			$11,186

Note that ITA 118.1(8) allows the allocation of gifts made by a partnership to its members, according to each member's share in the partnership.

KC 15-3

[*ITA 34.2(2), 96(1)(f)* – Income included in taxation year in which the partnership's taxation year ends & stub period income]

For its year ended December 31, 2022, A Ltd. must include $55,205 of business income calculated as follows:

Partnership profit for the year ending June 30, 2022 (50%)	$50,000
Add stub period income - $50,000 x 184 days/365 days	25,205
Deduct stub period income accrued in 2021	(20,000)
Net business income from the Partnership for tax purposes	$55,205

The partner, A Ltd., reports its share of the partnership's income in its taxation year which includes the partnership's year end.

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Since A Ltd. is entitled to more than 10% of the partnership's income, A Ltd. is required to include stub period income in its current fiscal period. The stub period income accrual is based on the number of days from the partnership year-end of June 30 to A Ltd.'s year-end of December 31 (184 days). This stub period inclusion is then deducted in arriving at A Ltd.'s December 31, 2023 income.

KC 15-4

[ITA: 96(1)(f), (g) – allocation of partnership income and losses]

Activity	Partnership	Tomas	Mari	Chris
Business income (70%/15%/15%)	$400,000	$280,000	$60,000	$60,000
Rental loss (1/3 each)	(30,000)	(10,000)	(10,000)	(10,000)
Interest income (1/3 each)	9,000	3,000	3,000	3,000
Taxable capital gain (1/3 each)	21,000	7,000	7,000	7,000
Allowable capital loss (1/3 each)	(15,000)	(5,000)	(5,000)	(5,000)
Total	$385,000	$275,000	$55,000	$55,000

Note that the income is subject to taxation, despite the fact that none of it has been withdrawn from the partnership. The partners are subject to tax on their share of the income earned by the partnership each year regardless of whether the partnership retains or distributes the profits. Profits retained by the partnership form part of each partner's capital. When accumulated profits are distributed to the partners, this constitutes a return of capital, which is not subject to further taxation.

KC 15-5

[ITA 233.1; Reg 229(1),(5) – Partnership information returns (T5013)]

Information required on partnership information return (T5013):

a) Income or loss of the partnership.
b) Name, address, and social insurance number (if applicable) of each partner.
c) Share of the income or loss for each partner.
d) Share of each deduction, credit, or other amount for each partner.
e) Share of scientific research and experimental development (SR&ED) for each partner.
f) Other information as may be required by the prescribed form.

Due date for partnership information returns:

a) Where all of the partners of the partnership are corporations, the information return is due within five months after the end of the fiscal period of the partnership [Reg. 229(5)(a)].

b) Where all of the partners of the partnership are individuals, the information return is due by March 31 of the calendar year following the calendar year in which the fiscal period of the partnership ends [Reg. 229(5)(b)].

c) Where the partners are a mixture of corporations and individuals, the information return is due by the earlier of (a) and (b) above [Reg. 229(5)(c)].

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KC 15-6

[*ITA 53(1)(e), 53(2)(c)* – ACB of Partnership Interest]

The adjusted cost base (ACB) of the partnership interest for each of the partners is computed as follows:

ACB – January 1, Year 1	$ 0
Add: Capital contribution - March, Year 1	75,000
Business income allocated ($300,000 x 50%)	150,000
Eligible dividends allocated ($20,000 x 50%)	10,000
Capital gains ($20,000 x 50%)	10,000
Tax-free capital dividend ($12,000 x 50%)	6,000
Deduct: Capital loss allocated ($4,000 x 50%)	(2,000)
Donations allocated ($3,000 x 50%)	(1,500)
Drawings	(60,000)
ACB of partnership interest, January 1, Year 2	$187,500

Additional notes:

1) Adjustments to the ACB with respect to capital contributions or drawings are made at the time of the contribution or drawing. In contrast, adjustments relating to allocated amounts from the partnership are made on the first day of the following fiscal period.

2) Each partner is required to include eligible dividends of $13,800, i.e., $10,000 x 138%, in net income for tax purposes for Year 1. However, it is the cash dividend received ($10,000) that is included in calculating the ACB of the partnership interest.

3) Each partner is required to include a taxable capital gain of $5,000, i.e., $10,000 x ½, in net income for tax purposes for Year 1. However, it is the entire capital gain ($10,000) that is included in computing the ACB of the partnership interest.

4) Each partner includes the $1,500 charitable donation allocated in the calculation of their donation tax credit on their personal tax return for Year 1.

KC 15-7

[*ITA 97(1)* – Contribution of Property to a Partnership at FMV]

For tax purposes, Lindsay is considered to have sold the land to the partnership at fair market value ($100,000) resulting in a taxable capital gain of $30,000 (1/2 x ($100,000 - $40,000)) for Lindsay. The partnership will have an adjusted cost base for the land of $100,000. Lindsay is considered to have made a capital contribution of $60,000 being the excess of the value of the land transferred over the $40,000 received by Lindsay. The adjusted cost base of her partnership interest will be increased by the $60,000.

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KC 15-8

[*ITA 97(2)* – Contribution of Property to a Canadian Partnership at tax value]

ITA 97(2) provides a rollover of property into a Canadian partnership that parallels the rollover provided by ITA 85(1) for transfers to a corporation. The major difference is that land held as inventory is eligible for an ITA 97(2) election whereas it is not eligible for an ITA 85(1) election.

The acceptable range for the elected proceeds is between the ACB of the land ($40,000) and the FMV ($100,000). The elected amount is also limited to the amount of non-partnership interest consideration received.

For tax purposes, Lindsay is considered to have sold the land to the partnership for proceeds equal to the elected amount (tax value ($40,000)) which defers the capital gain. The partnership will have an adjusted cost base for the land equal to the elected amount, $40,000. There is no increase in the adjusted cost base of Lindsay's partnership interest.

If Lindsay had taken no cash consideration and elected proceeds of $40,000, the ACB of her partnership interest would have increased by $40,000.

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