Tax memo

Canadian tax updates

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Joint Ventures—CRA ends policy allowing separate fiscal periods: How will this affect your company? (Updated March 23, 2012)

Considers the implications of a recent CRA announcement for real estate companies that use joint venture arrangements.

March 23, 2012

Updates our February 24, 2012 *Tax memo* entitled "Joint Ventures—CRA ends policy allowing separate fiscal periods: How will this affect your company" to reflect the CRA's announcement that the election to claim a transitional reserve must be filed by September 22, 2012.

A recent Canada Revenue Agency (CRA) announcement may adversely affect real estate companies that carry on projects or hold investment properties through joint ventures.

Background

The 2011 federal budget proposed rules to significantly limit or eliminate the opportunity for corporate partners in a partnership to benefit from any tax deferrals resulting from the partnership's ability to have a year end separate from that of its corporate partners. The proposed rules were passed into law on December 15, 2011. They are both complex and confusing. With the change to the tax rules applicable to partnerships, questions arose as to the status of the CRA's administrative approach to joint ventures and co-ownerships.

What does this mean for real estate companies?

Real estate companies commonly carry on projects or hold investment properties jointly with third parties through an unincorporated joint venture or co-ownership arrangement that, for various legitimate business and income tax reasons, the parties intend not to be a partnership. Although the tax law doesn't formally recognize these arrangements as a separate entity, the CRA had a long-standing policy permitting income earned through a joint venture to be determined using a fiscal period for the venture, if the participants had different tax year ends.

This policy was intended to ease the administrative burden of having to determine and report information based on each participant's own year end. As a side benefit, corporate participants in a joint venture could enjoy an income deferral similar to that arising for a partnership structure. A recent CRA announcement will end this practice, to be consistent with the new partnership anti-deferral regime noted above.

New partnership rules

In general, if a corporate partner's tax year end doesn't align with the fiscal period of the partnership, the new partnership rules require the corporation to accrue income (but not losses) for the "stub" period from the end of the partnership's year until the corporate year end.

The rules can be complex, especially when tiers of partnerships are involved or the partnership earns capital gains or investment income in addition to business income. In some cases, a transitional reserve that spreads the initial accrual of stub period income over up to five years can be available. Again, however, a host of qualification rules and ongoing limitations must be considered. Failure to accrue stub-period income properly can result in a penalty in a subsequent year: inclusion of income intended to offset the time-value of the partnership income deferral.

These rules generally apply to affected corporations for their tax years ending after March 22, 2011, the date of the original budget announcement.

New joint venture rules

Rather than requiring joint venture participants to adopt stub-period accrual rules similar to the partnership rules, the CRA announced on November 29, 2011, that joint venture arrangements simply will no longer be allowed to report income using a separate fiscal period.

As a result, corporate participants will have to report their actual share of joint venture income or loss up to the end of their own year end, for tax years ending after March 22, 2011. A transitional reserve will be allowed, in respect of the additional income included in that year by a corporate participant (i.e., any actual income of the participant for the stub period), using the same rules as for the partnership transitional reserve.

However, to claim a reserve, the corporation must file an election with its tax return for that first year. If that return has already been filed, the corporation can still access the reserve election by sending a letter to the CRA that includes the relevant information. The CRA has indicated that the election must be filed with the CRA by September 22, 2012.

Dealing with the new rules

In some cases, to avoid the additional work of determining joint venture results at multiple period ends, it might be possible to make the accounting period used for the joint venture align more closely with the year ends of the corporate participants. Alternatively, one or more of the corporate partners might consider requesting the CRA to permit a change to their own tax year end to align with the joint venture's reporting period.

Often, though, real estate corporations participate in multiple joint ventures, and many joint ventures have multiple participants. It might be impossible to find a common year end that accommodates all participants.

Some corporations might choose to simply estimate the additional income or loss for the stub period, rather than requiring the joint venture to prepare separate financial statements and tax information up to the corporate year end. The risk, however, is that inaccurate estimates will expose the corporation to potential interest and penalties from a related tax reassessment.

Conversion to partnership

Another approach might be to consider converting a joint venture arrangement into a partnership, so that the same fiscal period reporting can be maintained. In general, this can be accomplished on a tax-deferred basis. Unfortunately, complications can arise when the former joint venture participants have different tax costs for their shares of joint venture property transferred to the partnership, or when debt associated with the property exceeds the tax costs. As well, business reasons might have dictated that a partnership arrangement was not appropriate.

At a minimum, the income tax consequences of using a partnership can be very different from those of the former joint venture arrangement, so a review of the potential differences would be important. Finally, it is not clear whether a conversion to partnership form will allow continued claims for a joint venture transitional reserve that might otherwise be available.

PwC observations

If your company is a participant in a joint venture, you will have to carefully consider the impact this change in the CRA's policy will have on your tax reporting, and then determine what action is required.

Additional cash taxes in the transitional year might result from the loss of income deferrals previously enjoyed. It will not always be clear that a reserve is available to cushion this cash hit.

The additional administrative work required to determine joint venture information for tax purposes at multiple period ends should not be underestimated.

Developing a strategy to address this change in policy will be important. Consultation with your professional tax adviser is recommended.

PwC contacts

For help determining how these changes affect you or your company, please contact your PricewaterhouseCoopers LLP adviser, or:

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