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Joint Ventures — Ok, Now What?

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From time to time I've wondered, what if the tax laws become so complex that you can't comply with them? The issue has come up: for example, throughout the last decade, the foreign investment entity ("FIE") proposals were peppered with information requirements that simply were beyond reasonability. However, I have learned not to jump up and down, because in the end it usually doesn't come to that—at least where a lot of taxpayers are in the same boat. Cooler heads prevail (for example, the aforementioned FIE rules were scrapped in the 2010 Budget). Compromises are made. Life goes on.

But a Canada Revenue Agency ("CRA") release that recently came out relating to joint ventures has me scratching my head, especially because, for scores of taxpayers, it will be next to impossible to comply with the CRA's new policies.

A Brief History

In 1989, the CRA announced it would allow, on an administrative basis, a joint venture to establish a fiscal period that differed from the fiscal periods of the joint venture participants. (At the time, it was stated that the CRA position was intended to apply primarily where the participants have different fiscal periods, or where the participants have the same fiscal period but there are valid business reasons that justify a separate fiscal period for the joint venture—see 1989 Revenue Canada Round Table, Question 40.) As a result, it became commonplace, when filing, to include the joint venture's income in the participant taxpayer's taxation year in which the fiscal period of the joint venture ended—even though this treatment was not explicitly recognized in the Income Tax Act itself. This, of course, allowed for a deferral of a joint venturer's income, for example, if the joint venturer's fiscal year ended just before that of the joint venture.

In other words, the administrative policy put joint ventures on the same footing as partnerships in this regard—in fact, on an even better footing. As readers know, unlike a partnership, a joint venture allowed capital cost allowance and other discretionary deductions to be claimed at the joint venturer level, so that differing claims could be made by the respective joint venturers. Based on this, it became common for real estate co-ventures (at least) to prefer the joint venture structure over a partnership, even though, in many cases, a joint venture might be difficult to legally distinguish from a partnership.

The New Regime

Fast forward to the 2011 federal Budget, which put an end to tax-deferred year ends for partnerships. As soon as the proposals came out, taxpayers were left to wonder, can joint ventures be far behind? In June, an announcement at the 2011 Prairie Provinces Tax Conference put an end to this speculation: the CRA confirmed that joint ventures would be put on a similar footing to partnerships, complete with transitional rules for stub period income.¹ Further information is contained in Document No. 2011-0429581E5, released on November 29, 2011. The details of the release are contained in my January 2012 article ("What's New", Tax Notes No. 588). In a nutshell,

the release itself indicates that, for joint venturers with taxation years ending after March 22, income from joint ventures will be required to be calculated for each participant taxpayer based on the fiscal period of the particular taxpayer; that is, deferred joint venture year ends will not be recognized. However, transitional relief similar to the partnership rules will potentially apply to the extra income that has to be reported, so that a deferral of the extra income will be offered.

As observed in my article, it would be impractical, if not impossible, for many joint venturers (e.g., for minority participants with small interest) to undertake a calculation of income based on their particular year end. In fact, this led at least one observer to question whether the joint venture vehicle itself is still manageable in light of these new policies.

In fact, as I mentioned in my article, there was one hope: perhaps, as in the partnership rules, an approximation could be permitted, based on principles similar to those in the new partnership rules (i.e., current income could be estimated based on the previous year's partnership income, subject to adjustments). The trouble is there was no mention of this alternative in the release.

However, in Document No. 2011-0431271E5, dated January 10, 2012, the CRA announced that this approximation method is off the table. The document itself offers few clues as to the reasoning behind this decision, other than indicating that a consultation process had been undertaken, in which the formulaic approach to compiling stub period income was considered. This process took into account tax policy issues, as well as the administrative feasibility of applying an administrative policy in a similar manner as that provided with respect to partnerships. Unfortunately, however, the final paragraph of the document confirms that, for taxation years ending after March 22, 2011, actual income earned through joint ventures must be calculated for each participant based on that participant's fiscal period.

Now What?

So we are back to an earlier part of the article—no, not the part about cooler heads, but the part about the rules being unmanageable. In fact, we are in a worse position. The partnership rules recognize complexities in calculating income on the current basis by creating special rules to approximate income for partners with different year ends than the partnership. But in case taxpayers might have been tempted to try a similar approximation with joint ventures, the latest CRA missive says that this is not in keeping with CRA policy.

There does not appear to be a wide range of strategies to overcome these complexities. Some possibilities include changing corporate year ends (and/or the year end of the joint venture itself) so that the venturers' year ends coincide with that of the joint venture. Alternatively, the joint venture interest could be rolled into a new corporation with a conforming year end (in Ontario, land transfer tax can typically be deferred). Another possibility is converting the joint venture into a partnership. But this may be more easily said than done. If the co-venturers have differing cost amounts of the joint venture properties (e.g., if differing depreciation has been claimed by the respective joint venturers), an agreement may have to be reached regarding compensation for joint venturers who contribute property with an increased cost amount.

As stated above, in many cases, a joint venture may have similar attributes to a partnership.² It may be tempting to take the position that the joint venture is a partnership, so that the rules approximating current income (in section 34.2) may be formally used. However, careful consideration should be given to the implications of a filing position that contradicts not only a taxpayer's previous filing position, but that of the other would-be joint venturers. (For example, GST/HST compliance might be incorrect; consider also representations given to bankers, etc.) Consideration should also be given to the impact on transitional reserves; the analysis of this issue may be hampered by the fact that the CRA appears to have offered relatively little insight into the

details of the transitional rules (which in general will be applied in a manner similar to or consistent with the partnership rules³). Also, the joint venture agreement should be checked with respect to the feasibility of the foregoing possibilities.

But to be honest, these possibilities are not exactly panaceas. So if a client is simply facing issues of compliance with CRA policies, then what? In some cases (e.g., if a client has a major interest in a joint venture), with monthly financial statements, it may be viable to cobble together sufficient information to comply with CRA policies. But in many cases (e.g., a minor interest or long-standing joint tenancy which has been in the family for many years), contact with the person running the venture may have become limited to cheques for the rent and annual statements received in the mail. I think it is fair to say that in some cases, compliance with the new CRA policies is, at best, a time-consuming possibility.

Going forward, professionals involved in structuring co-ventures should be familiar with the new tax traps. If the approximation methodology is truly off the table, I think that the joint venture vehicle will become less commonplace, unless promoters are willing to develop sophisticated financial information mechanisms. But I'm still hoping that the CRA will change its tune.

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Notes:

¹ See Document No. 2011-0403081C6, June 6, 2011.

² Alberta is considering a statutory definition of a joint venture. For details, see "Partnership Status Opt-Out Proposed for Joint Ventures", Strawson and Wong, *Tax for the Owner-Manager*, October 2011, Canadian Tax Foundation.

³ Document No. 2011-0431461E5, dated January 10, 2012, has an example of the application of the transitional rules, which assumes a joint venture with a calendar year end and two corporate co-venturers whose year ends are November 30 and January 31, respectively. It mentions that paragraphs 34.2(11) (a), (b), and (c) and subsections 34.2(5), 34.2(13), 34.2(18), and 34.2(15) of the Act will be applied in a "similar" manner for participant taxpayers of joint ventures. It does not specifically mention subsection 34(14), which potentially restores transitional relief for transfers of partnership interests to related or affiliated corporations. It also confirms that income for which a deduction is available under section 112 or 113 will not qualify for transitional relief. The Technical Interpretation also confirms the extension of the filing deadline of elections to qualify for transitional relief to September 22, 2012.