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LIMITED PARTNERSHIPS

This newsletter has, at various times since its inception in the mid-1970's, examined and commented upon various legal structures and mechanisms available for the efficient establishment and conduct of a variety of business enterprises. One such structure, which has not been subject to our attention or commentary in recent times, is the limited partnership and its utility in creating an extraordinary flexible investment and operating entity. This edition of our newsletter will examine the general legislative environment of the limited partnership in British Columbia, develop and examine the purpose and objective for establishing a limited partnership, review certain tax implications related to their formation and conclude with a review of the general issues of formation and operation of a limited partnership pursuant to the *Partnership Act* (British Columbia) R.S.B.C. 1996 c.348 (the "Act").

At the outset, it is important to recognize that a limited partnership is a creature of statute, originating from Part III of the Act. In essence, a limited partnership is a partnership which has been enhanced by the Act, to provide limited liability to certain members of the partnership who are not involved in the management of the partnership. Fundamental to the limited partnership's structure, is the principle that it is the general partner who carries on the business of the partnership and

it is the limited partners who are passive in the management of the partnership and whose liability extends only to the capital or property that such limited partner agreed to contribute to the partnership. It is the general partner who is fully liable for the debts and obligations of the limited partnership.¹ It is on this basis that the limited partner is distinguished from the general partner.

Purpose of Limited Partnership

The public policy, economic and business theory supporting the creation of limited partnerships in the Act, is based on the notion that they will act to expand the pool of capital available to businesses by offering passive partners (i.e. the limited partners) with limited liability. Having said that, there is a very real and significant tax driven motivation supporting the use of limited partnerships.

On a comparative basis, profits from a limited partnership are subject to only one level of taxation, whereas corporations are subject to double taxation.² Moreover, business losses can only be used by the corporation against other income generated by it. However, be-

cause of the flow-through nature of a limited partnership, losses in the limited partnership can be allocated to the partners directly, according to the provisions of the prevailing partnership agreement, which may then be used to off-set that limited partner's individual taxable income.

This tax-driven advantage motivates business participants to utilize limited partnerships in industries that enjoy significant write-offs for tax purposes (e.g. farming, film, oil and gas, mining, etc.) and industries with significant research and development costs, or with large investments in capital qualifying for high C.C.A.³ rates.

Tax Implications

In addition to the flow-through advantages of limited partnerships and the various means of dealing with depreciable property through capital cost allowance as noted above, there are further tax related matters at issue when considering the formation of a limited partnership. By way of example, limited partners are restricted from deducting an amount greater than the capital that they put "at risk" in relation to the partnership. Another tax related characteristic of the limited partnership is that income from the partnership generally retains its characteristics with respect to source and nature, even after it

¹ Planning Note: Generally the general partner is a corporation, to ensure that the liability of the general partner is limited to the underlying assets of the general partner corporation, and not to an individual.

² The affects of double taxation at the corporate level are especially important to profitable corporations not qualifying as small business corporations.

³ "C.C.A." or "Capital Cost Allowance" is a method for deducting the costs of depreciable property over a period of years. Depreciable property includes buildings, office equipment and furniture, etc. The entire costs of these items may not be deductible in one year. Capital Cost Allowance varies depending on the type of property purchased.

has been distributed out into the partners' hands. In addition, it should be remembered that those partners are bound by the elections of the partnership as a whole.

Finally, and very significantly, discretion exists with respect to the allocation of income or loss amongst the partners. Such an allocation is affected by the terms of the partnership agreement. Having said that, one should be weary of straying too far from a *pro rata* allocation of income or loss. Section 103 of the *Income Tax Act (Canada)* contains certain provisions which attack arrangements meant to reduce or postpone income taxes otherwise payable.

Formation of a Limited Partnership

While an ordinary partnership can be formed from a simple agreement of the partners to commence business in common with a view to a profit, a limited partnership requires compliance with the Act. In this regard, section 51 of the Act sets out the formal requirements for establishing a limited partnership in British Columbia. It is important to note that a limited partnership is only formed when a certificate is filed with the Registrar, signed by each person who is, on the formation of the limited partnership, a general partner. Generally speaking, the certificate must set out the obligations and timing for contributions of the limited partners to the limited partnership, the ability to transfer limited partnership interests and admit additional limited partners, the extent to which one or more limited partner has greater rights than the others, general issues of bankruptcy, death, retirement, mental incompetence or dissolution of a general partner, rights to receive property other than cash

and any provisions dealing with the appointment or retirement of a general partner.

The limited partnership agreement generally deals with a variety of additional aspects, generally focusing on the financial management and affairs of the business to be conducted by the limited partnership. Generally, these would include issues of contributions of capital, income, loss and cash distributions, compensation of general partner, fiscal matters, ownership and sale of partnership property, transfers of partnership interests, removal of general partner, termination of the limited partnership, and other matters specific to the management and operation of the limited partnership business.

Operational Affairs

Generally speaking, the following restrictions and limitations must be borne in mind, both during the formation and operation of the limited partnership:

- There is limited permitted participation by the limited partners in the business, affairs and decisions to be made with regard to the limited partnership;
- Except as provided in Part III of the Act, a limited partner is not liable for the obligations of the limited partnership, beyond the amount of property the limited partner contributes or agrees to contribute to the limited partnership;
- If the limited partner takes part in the management of the business, the limited partner may lose limited liability status;
- The limited partners are specifically provided with certain rights by the Act, including the right to obtain partnership information;

- The duties of a general partner to the limited partner are the same as the duties of any partner to any other partner under normal partnership law.

Finally, it is important to bear in mind that the passive involvement of the limited partners and the transferability of the partnership interest may make the *Securities Act (British Columbia)*⁴ applicable, in which case there may be certain disclosure requirements that must be addressed and complied with.

Conclusion

Parties entering into a limited partnership should not underestimate the importance of the partnership agreement. Common law partnership law remains applicable to limited partnerships, and it is important to remember that the agreement is paramount in partnership law. Moreover, any issues not addressed by Part III of the Act is governed by the agreement. The agreement, therefore, is crucial to the ongoing fiscal and administrative well-being of the partners, both general and limited.

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Please find accompanying this newsletter, a copy of the lawyer profile of our newest associate, Mr. Phil Walters, who joins our firm from eight years of service to Comstock Canada Ltd., where Phil provided legal and commercial advice in the area of complex construction matters, as Comstock's General Counsel.

Volume 17, Issue 2, 2004

⁴ Or such similar legislation, depending on where such limited partnership units or interests are offered.